

FIRST MERCHANTS CORP  
Form 10-K  
February 27, 2015

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

FORM 10-K

[Mark One]

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-17071

FIRST MERCHANTS CORPORATION

(Exact name of registrant as specified in its charter)

Indiana

35-1544218

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification No.)

200 East Jackson

Muncie, Indiana

47305-2814

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: (765)747-1500

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Name of each exchange on which registered

Common Stock, \$0.125 stated value per share

The NASDAQ Stock Market

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant(1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every interactive data file required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files) Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best

of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. Large accelerated filer  Accelerated filer  Non-accelerated filer  Small Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value (not necessarily a reliable indication of the price at which more than a limited number of shares would trade) of the voting stock held by non-affiliates of the registrant was \$762,144,000 as of the last business day of the registrant's most recently completed second fiscal quarter (June 30, 2014).

As of February 20, 2015 there were 37,680,604 outstanding common shares, without par value, of the registrant.

DOCUMENTS INCORPORATED BY REFERENCE

Documents	Part of Form 10-K into which incorporated
Portions of the Registrant's Definitive	Part III (Items 10 through 14)
Proxy Statement for Annual Meeting of	
Shareholders to be held May 4, 2015	

Table of Contents

## TABLE OF CONTENTS

## FIRST MERCHANTS CORPORATION

<u>Statement Regarding Forward-Looking Statements</u>	<u>3</u>
 <u>PART I</u>	
Item 1. <u>Business</u>	<u>4</u>
Item 1A. <u>Risk Factors</u>	<u>21</u>
Item 1B. <u>Unresolved Staff Comments</u>	<u>24</u>
Item 2. <u>Properties</u>	<u>25</u>
Item 3. <u>Legal Proceedings</u>	<u>25</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>25</u>
<u>Supplemental Information - Executive Officers of the Registrant</u>	<u>26</u>
 <u>PART II</u>	
Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>27</u>
Item 6. <u>Selected Financial Data</u>	<u>30</u>
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>31</u>
Item 7A. <u>Quantitative and Qualitative Disclosure about Market Risk</u>	<u>46</u>
Item 8. <u>Financial Statements and Supplementary Data</u>	<u>47</u>
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>102</u>
Item 9A. <u>Controls and Procedures</u>	<u>102</u>
Item 9B. <u>Other Information</u>	<u>103</u>
 <u>PART III</u>	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	<u>104</u>
Item 11. <u>Executive Compensation</u>	<u>104</u>
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>104</u>
Item 13. <u>Certain Relationships, Related Transactions and Director Independence</u>	<u>104</u>
Item 14. <u>Principal Accountant Fees and Services</u>	<u>104</u>
 <u>PART IV</u>	
Item 15. <u>Exhibits and Financial Statement Schedules</u>	<u>105</u>

Table of Contents

FORWARD-LOOKING STATEMENTS

First Merchants Corporation (the “Corporation”) from time to time includes forward-looking statements in its oral and written communication. The Corporation may include forward-looking statements in filings with The Securities and Exchange Commission (“SEC”), such as Form 10-K and Form 10-Q, in other written materials and oral statements made by senior management to analysts, investors, representatives of the media and others. The Corporation intends these forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and the Corporation is including this statement for purposes of these safe harbor provisions. Forward-looking statements can often be identified by the use of words like “believe”, “continue”, “pattern”, “estimate”, “project”, “intend”, “anticipate”, “expect” and similar expressions or future or conditional verbs such as “will”, “would”, “should”, “could”, “might”, “can”, “may” or similar expressions. These forward-looking statements include:

- statements of the Corporation’s goals, intentions and expectations;
- statements regarding the Corporation’s business plan and growth strategies;
- statements regarding the asset quality of the Corporation’s loan and investment portfolios;
- and
- estimates of the Corporation’s risks and future costs and benefits.

These forward-looking statements are subject to significant risks, assumptions and uncertainties, including, among other things, those discussed in Item 1A, “RISK FACTORS”.

Because of these and other uncertainties, the Corporation’s actual future results may be materially different from the results indicated by these forward-looking statements. In addition, the Corporation’s past results of operations do not necessarily indicate its future results.

Table of Contents

PART I: ITEM 1. BUSINESS

PART I

ITEM 1. BUSINESS

GENERAL

First Merchants Corporation (the “Corporation”) is a financial holding company headquartered in Muncie, Indiana and was organized in September 1982. The Corporation’s Common Stock is traded on NASDAQ’s Global Select Market System under the symbol FRME. The Corporation has one full-service bank charter, First Merchants Bank, National Association (the “Bank”), which opened for business in Muncie, Indiana, in March 1893. The Bank also operates Lafayette Bank and Trust, Commerce National Bank, Community Bank of Noblesville and First Merchants Trust Company as divisions of First Merchants Bank, N.A. The Bank includes 106 banking locations in twenty-six Indiana, two Illinois and two Ohio counties. In addition to its branch network, the Corporation’s delivery channels include ATMs, check cards, remote deposit capture, interactive voice response systems and internet technology. The Corporation’s business activities are currently limited to one significant business segment, which is community banking.

Through the Bank, the Corporation offers a broad range of financial services, including accepting time deposits, savings and demand deposits; making consumer, commercial, agri-business and real estate mortgage loans; renting safe deposit facilities; providing personal and corporate trust services; providing full-service brokerage; and providing other corporate services, letters of credit and repurchase agreements.

The Corporation also operates First Merchants Insurance Services, Inc., operating as First Merchants Insurance Group, a full-service property, casualty, personal lines, and employee benefit insurance agency headquartered in Muncie, Indiana.

All inter-company transactions are eliminated during the preparation of consolidated financial statements.

As of December 31, 2014, the Corporation had consolidated assets of \$5.8 billion, consolidated deposits of \$4.6 billion and stockholders’ equity of \$727 million. As of December 31, 2014, the Corporation and its subsidiaries had 1,415 full-time equivalent employees.

AVAILABLE INFORMATION

The Corporation makes its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, available on its website at [www.firstmerchants.com](http://www.firstmerchants.com) without charge, as soon as reasonably practicable, after such reports are electronically filed with, or furnished to, the Securities and Exchange Commission. These documents can also be read and copied at the Securities and Exchange Commission’s Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the public reference room. SEC filings are also available to the public at the Securities and Exchange Commission’s website at [www.sec.gov](http://www.sec.gov). Additionally, the Corporation will also provide without charge, a copy of its Annual Report on Form 10-K to any shareholder by mail. Requests should be sent to Cynthia Holaday, Shareholder Relations, First Merchants Corporation, P.O. Box 792, Muncie, IN 47308-0792.

ACQUISITION POLICY

The Corporation anticipates that it will continue its policy of geographic expansion of its banking business through the acquisition of banks whose operations are consistent with its banking philosophy. Management routinely explores opportunities to acquire financial institutions and other financial services-related businesses and to enter into strategic alliances to expand the scope of its services and its customer base.

On November 7, 2014, the Corporation acquired 100 percent of Community Bancshares, Inc. ("Community"). Community was headquartered in Noblesville, Indiana and had 10 full-service banking centers serving central Indiana. Pursuant to the merger agreement, each outstanding share of common stock of Community was converted into the right to receive either (a) 4.0926 shares of the Corporation's common stock, plus cash in lieu of fractional shares; or (b) \$85.94 in cash, based upon shareholder elections. The Corporation paid \$14.2 million in cash and issued approximately 1.6 million shares of common stock, valued at approximately \$35.0 million, for a total purchase price of approximately \$49.2 million.

Effective November 12, 2013, the Corporation acquired 100 percent of CFS Bancorp ("CFS") in an all stock transaction. CFS was headquartered in Munster, Indiana and had 20 banking centers in northwestern Indiana and northeastern Illinois. Pursuant to the merger agreement, the shareholders of CFS received 0.65 percent of a share of the Corporation's common stock for each share of CFS Bancorp common stock held. The Corporation issued approximately 7.1 million shares of common stock, which was valued at approximately \$135.6 million.

The details of the Community and CFS acquisitions can be found in Note 3. BUSINESS COMBINATIONS, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

Effective February 10, 2012, the Bank assumed substantially all of the deposits and certain other liabilities and acquired certain assets of SCB Bank ("SCB"), a federal savings bank headquartered in Shelbyville, Indiana, from the Federal Deposit Insurance Corporation ("FDIC"), as receiver for SCB, pursuant to the terms of the Purchase and Assumption Agreement - Modified Whole Bank; All Deposits, entered into by the Bank, the FDIC as receiver of SCB and the FDIC. Additional details of this transaction can be found in Note 2. PURCHASE AND ASSUMPTION, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

Table of Contents

PART I: ITEM 1. BUSINESS

On January 5, 2015, the Corporation and C Financial Corporation, an Ohio corporation (“C Financial”), entered into an Agreement and Plan of Reorganization and Merger (the “Merger Agreement”), pursuant to which, C Financial will, subject to the terms and conditions of the Merger Agreement, merge with and into First Merchants (the “Merger,”) whereupon the separate corporate existence of C Financial will cease and First Merchants will survive. Immediately following the Merger, Cooper State Bank, an Ohio state bank and wholly-owned subsidiary of C Financial, will be merged with and into First Merchants Bank, National Association, a national bank and wholly-owned subsidiary of First Merchants, with First Merchants Bank, National Association continuing as the surviving bank. The Merger Agreement has been approved by the Boards of Directors of each of First Merchants and C Financial, but the consummation of the Merger is conditioned upon the approval of the C Financial shareholders and certain regulatory authorities as well as satisfaction of customary closing conditions. The Merger Agreement provides that upon the effective date of the Merger (the “Effective Date”), the shareholders of C Financial shall be entitled to receive an aggregate of \$14,500,000 in cash in exchange for all of the outstanding shares of C Financial common stock, \$1.00 par value. Subject to C Financial common shareholders’ approval of the Merger Agreement, regulatory approvals and other customary closing conditions, the parties anticipate completing the Merger in the second quarter of 2015. Additional details of this transaction can be found in Note 28. SUBSEQUENT EVENTS, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

COMPETITION

The Bank is located in Indiana, Ohio and Illinois counties where other financial services companies provide similar banking services. In addition to the competition provided by the lending and deposit gathering subsidiaries of national manufacturers, retailers, insurance companies and investment brokers, the Bank competes vigorously with other banks, thrift institutions, credit unions and finance companies located within its service areas.

REGULATION AND SUPERVISION OF FIRST MERCHANTS CORPORATION AND SUBSIDIARIES

Bank Holding Company Regulation

The Corporation is registered as a bank holding company and has elected to be a financial holding company. It is subject to the supervision of, and regulation by the Board of Governors of the Federal Reserve System (“Federal Reserve”) under the Bank Holding Company Act of 1956 (the “BHC Act”), as amended. Bank holding companies are required to file periodic reports with and are subject to periodic examination by the Federal Reserve. The Federal Reserve has issued regulations under the BHC Act requiring a bank holding company to serve as a source of financial and managerial strength to the Bank. Thus, it is the policy of the Federal Reserve that a bank holding company should stand ready to use its resources to provide adequate capital funds to the Bank during periods of financial stress or adversity. Additionally, under the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), a bank holding company is required to guarantee the compliance of any subsidiary bank that may become “undercapitalized” (as defined in the FDICIA section of this Form 10-K) with the terms of any capital restoration plan filed by such subsidiary with its appropriate federal banking agency. Under the BHC Act, the Federal Reserve has the authority to require a bank holding company to terminate any activity or relinquish control of a non-bank subsidiary (other than a non-bank subsidiary of a bank) upon the determination that such activity constitutes a serious risk to the financial stability of any bank subsidiary.

The BHC Act requires the Corporation to obtain the prior approval of the Federal Reserve before:

acquiring direct or indirect control or ownership of any voting shares of any bank or bank holding company if, after such acquisition, the bank holding company will directly or indirectly own or control more than 5 percent of the

voting shares of the bank or bank holding company;  
merging or consolidating with another bank holding company; or  
acquiring substantially all of the assets of any bank.

The BHC Act generally prohibits bank holding companies that have not become financial holding companies from (i) engaging in activities other than banking or managing or controlling banks or other permissible subsidiaries, and (ii) acquiring or retaining direct or indirect control of any company engaged in the activities other than those activities determined by the Federal Reserve to be closely related to banking or managing or controlling banks.

#### Capital Adequacy Guidelines for Bank Holding Companies

The BHC Act does not place territorial restrictions on such non-banking related activities. The Corporation is required to comply with the Federal Reserve's risk-based capital guidelines. These guidelines require a minimum ratio of capital to risk-weighted assets of 8 percent (including certain off-balance sheet activities such as standby letters of credit). At least half of the total required capital must be "Tier 1 capital," consisting principally of stockholders' equity, noncumulative perpetual preferred stock, a limited amount of cumulative perpetual preferred stock and minority interest in the equity accounts of consolidated subsidiaries, less certain goodwill items. The remainder may consist of a limited amount of subordinate debt and intermediate-term preferred stock, certain hybrid capital instruments and other debt securities, cumulative perpetual preferred stock, and a limited amount of the general loan loss allowance.



Table of Contents

## PART I: ITEM 1. BUSINESS

In addition to the risk-based capital guidelines, the Federal Reserve has adopted a Tier 1 (leverage) capital ratio under which the Corporation must maintain a minimum level of Tier 1 capital to average total consolidated assets.

The following are the Corporation's regulatory capital ratios as of December 31, 2014:

	Corporation	Regulatory Minimum Requirement	
Tier 1 risk-based capital ratio	12.63	% 4.00	%
Total risk-based capital ratio	15.34	% 8.00	%

In July 2013, the United States banking regulators adopted new capital rules which modified the risk-based capital and leverage capital requirements applicable to bank holding companies and depository institutions. These rules are commonly known as "Basel III". These new rules will be phased in for the Corporation and the Bank beginning on January 1, 2015. The following is a summary of the major changes related to risk based capital:

- higher minimum capital requirements, including a new "common equity tier 1 capital" ratio of 4.5 percent, a tier 1 capital ratio of 6 percent, a total capital ratio of 8 percent and a minimum leverage ratio of 4 percent;
- stricter eligibility for regulatory capital instruments;
- restrictions on the payment of capital distributions (including dividends) and certain discretionary bonus payments to executive officers if certain thresholds are not met under a new "capital conservation buffer" as defined in the rules;
- replacement of the external credit ratings approach to standards of creditworthiness with a simplified supervisory formula approach;
- stricter limitations on the extent to which certain mortgage servicing assets, deferred tax assets and investments in unconsolidated financial institutions may be included in common equity tier 1 capital;
- increased risk weights for past due loans, certain commercial real estate loans and certain equity exposures.

The implementation of the new Basel III standards is not expected to have a material impact on the Corporation or the Bank.

### Bank Regulation

The Bank is supervised, regulated and examined by the Office of the Comptroller of the Currency (the "OCC"). The OCC has the authority to issue cease-and-desist orders if it determines that activities of the Bank regularly represent an unsafe and unsound banking practice or a violation of law. Federal law extensively regulates various aspects of the banking business such as reserve requirements, truth-in-lending and truth-in-savings disclosures, equal credit opportunity, fair credit reporting, trading in securities and other aspects of banking operations. Current federal law also requires banks, among other things, to make deposited funds available within specified time periods.

### Bank Capital Requirements

The OCC has adopted risk-based capital ratio guidelines to which national banks are subject. The guidelines establish a framework that makes regulatory capital requirements more sensitive to differences in risk profiles. Risk-based capital ratios are determined by allocating assets and specified off-balance sheet commitments to four risk-weighted categories, with higher levels of capital being required for the categories perceived as representing greater risk.

Like the capital guidelines established by the Federal Reserve, these guidelines divide a bank's capital into tiers. Banks are required to maintain a total risk-based capital ratio of 8 percent. The OCC may, however, set higher capital

requirements when a bank's particular circumstances warrant. Banks experiencing or anticipating significant growth are expected to maintain capital ratios, including tangible capital positions, well above the minimum levels.

In addition, the OCC established guidelines prescribing a minimum Tier 1 leverage ratio (Tier 1 capital to adjusted total assets as specified in the guidelines). Currently, these guidelines provide for a minimum Tier 1 leverage ratio of 3 percent for banks that meet specified criteria, including that they have the highest regulatory rating and are not experiencing or anticipating significant growth. All other banks are required to maintain a Tier 1 leverage ratio of 3 percent plus an additional 1 to 2 percent. The Bank exceeded the minimum risk-based capital guidelines of the OCC as of December 31, 2014. The capital standards applicable to the Bank will begin to change on January 1, 2015 in accordance with the Basel III rules discussed above. The implementation of the new Basel III standards is not expected to have a material impact on the Corporation or the Bank.

#### FDIC Improvement Act of 1991

The FDICIA requires, among other things, federal bank regulatory authorities to take "prompt corrective action" with respect to banks, which do not meet minimum capital requirements. For these purposes, FDICIA establishes five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. The Federal Deposit Insurance Corporation ("FDIC") has adopted regulations to implement the prompt corrective action provisions of FDICIA.

Table of Contents

PART I: ITEM 1. BUSINESS

“Undercapitalized” banks are subject to growth limitations and are required to submit a capital restoration plan. A bank’s compliance with such plan is required to be guaranteed by the bank’s parent holding company. If an “undercapitalized” bank fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized. “Significantly undercapitalized” banks are subject to one or more restrictions, including an order by the FDIC to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets and cease receipt of deposits from correspondent banks, and restrictions on compensation of executive officers. “Critically undercapitalized” institutions may not, beginning 60 days after becoming “critically undercapitalized,” make any payment of principal or interest on certain subordinated debt or extend credit for a highly leveraged transaction or enter into any transaction outside the ordinary course of business. In addition, “critically undercapitalized” institutions are subject to appointment of a receiver or conservator.

As of December 31, 2014, the Bank was “well capitalized” based on the “prompt corrective action” ratios described above. It should be noted that a bank’s capital category is determined solely for the purpose of applying the OCC’s “prompt corrective action” regulations and that the capital category may not constitute an accurate representation of the bank’s overall financial condition or prospects.

Volcker Rule

In December 2013, United States banking regulators adopted final rules implementing the Volcker Rule under the Dodd-Frank Act. The Volcker Rule places certain limitations on the trading activity of insured depository institutions and their affiliates subject to certain exceptions. The restricted trading activity includes purchasing or selling certain types of securities or instruments in order to benefit from short-term price movements or to realize short-term profits. Exceptions to the Volcker Rule include trading in certain U.S. Government or other municipal securities and trading conducted in certain capacities as a broker or other agent, as a fiduciary on behalf of customers, to satisfy a debt previously contracted, repurchase and securities lending agreements and risk-mitigating hedging activities. The Volcker Rule also prohibits banking institutions from having an ownership interest in a hedge fund or private equity fund. The implementation of the new Volcker Rule did not have a material impact on the Corporation or the Bank.

LEGISLATIVE AND REGULATORY INITIATIVES TO ADDRESS FINANCIAL AND ECONOMIC CRISES

Small Business Lending Program

In 2010, Congress established the Small Business Lending Fund (“SBLF”) under the Small Business Jobs Act of 2010 encouraging lending to small business by providing capital to qualified community banks with assets of less than \$10 billion. On September 22, 2011, the Corporation became a participant in SBLF by entering into a Securities Purchase Agreement (the “Purchase Agreement”) with the U.S. Department of Treasury (“Treasury”), pursuant to which the Corporation issued 90,782.94 shares of the Corporation’s Senior Non-Cumulative Perpetual Preferred Stock, Series B (the “Series B Preferred Stock”), having a liquidation amount per share equal to \$1,000, for a total purchase price of \$90,782,940.

The Series B Preferred Stock was entitled to receive non-cumulative dividends, payable quarterly, on each January 1, April 1, July 1 and October 1, beginning October 1, 2011. The dividend rate was based on the level of the Bank’s lending to small businesses. The Series B Preferred Stock was non-voting, except in limited circumstances, and was issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended.

On January 3, 2013, the Corporation redeemed 22,695.94 shares of the Series B Preferred Stock held by the Treasury at an aggregate redemption price of \$22,695,940 plus accrued but unpaid dividends. On July 2, 2013, the Corporation redeemed an additional 34,044 shares of the Series B Preferred Stock held by the Treasury at an aggregate redemption price of \$34,044,000 plus accrued but unpaid dividends. On November 22, 2013, the Corporation redeemed the final 34,043 shares of the Series B Preferred Stock held by the Treasury at an aggregate redemption price of \$34,043,000 plus accrued but unpaid dividends. This redemption resulted in all of the outstanding shares of Series B Preferred Stock having been redeemed and the Corporation ending its participation in the SBLF program.

#### Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) into law. The Dodd-Frank Act is likely to have a broad impact on the financial services industry, including significant regulatory and compliance changes. Many of the requirements called for in the Dodd-Frank Act will be implemented over time and most will be subject to various federal agencies implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies through regulatory guidance, the full extent of the impact such requirements will have on the financial services industry, and on operations specifically, is currently unclear. The changes resulting from the Dodd-Frank Act may materially impact the profitability of the Corporation’s business activities, require changes to certain business practices, impose more stringent capital, liquidity and leverage requirements or otherwise adversely affect the business. At a minimum, the Dodd-Frank Act is likely to:

- increase the cost of operations due to greater regulatory oversight, supervision and examination of banks and bank holding companies, including higher deposit insurance premiums;
- limit the Corporation’s ability to raise additional capital through the use of trust preferred securities as new issuances of these securities may no longer be included as Tier 1 capital;
- reduce the flexibility to generate or originate certain revenue-producing assets based on increased regulatory capital standards; and
- limit the ability to expand consumer product and service offerings due to anticipated stricter consumer protection laws and regulations.

Table of Contents

PART I: ITEM 1. BUSINESS

The timing and extent of these increases and limitations will remain unclear until the underlying implementing regulations are promulgated by the applicable federal agencies. In the interim, the Corporation's management is currently taking steps to best prepare for the implementation and to minimize the adverse impact on the business, financial condition and results of operation.

On February 7, 2011, the FDIC adopted final rules implementing a portion of the Dodd-Frank Act relating to deposit insurance assessments. The rules modify the base amount for a financial institution's insurance assessments from an institution's insured deposits to the difference between an institution's daily average consolidated assets and its daily average tangible equity. The rules also eliminated the requirement that the FDIC provide rebates to institutions on their deposit premiums once the reserve ratio exceeded 1.5 percent. These new rules became effective on April 1, 2011.

Deposit Insurance

The Bank is insured up to regulatory limits by the FDIC; and, accordingly, is subject to deposit insurance assessments to maintain the Deposit Insurance Fund administered by the FDIC. The FDIC has adopted regulations establishing a permanent risk-related deposit insurance assessment system. Under this system, the FDIC places each insured bank in one of four risk categories based on (i) the bank's capital evaluation, and (ii) supervisory evaluations provided to the FDIC by the bank's primary federal regulator. Each insured bank's annual assessment rate is then determined by the risk category in which it is classified by the FDIC.

When Dodd-Frank became effective, it permanently raised the previous Standard Maximum Deposit Insurance Amount ("SMDIA") to \$250,000. The FDIC insurance coverage limit applies per depositor, per insured depository institution for each account ownership category. This provision became effective for depositors December 31, 2010.

On November 9, 2010, the FDIC implemented section 343 of the Dodd-Frank Act providing unlimited insurance coverage on noninterest-bearing transaction accounts. Beginning December 31, 2010, through December 31, 2012, all noninterest-bearing transaction accounts were fully insured, regardless of the balance of the account, at all FDIC-insured institutions. As of January 1, 2013, noninterest-bearing transaction deposit accounts are no longer insured separately from other accounts at the same FDIC-insured institution. Instead, noninterest-bearing transaction accounts will be added to other accounts, and the aggregate balance insured up to at least the Standard Maximum Deposit Insurance Amount of \$250,000, at each institution.

DIVIDEND LIMITATIONS

National banking laws restrict the amount of dividends that an affiliate bank may declare in a year without obtaining prior regulatory approval. National banks are limited to the bank's retained net income (as defined) for the current year plus those for the previous two years. At December 31, 2014, the Corporation's affiliates (including the Bank and other affiliates) had a total of \$23,340,000 retained net profits available for 2015 dividends to the Corporation without prior regulatory approval.

BROKERED DEPOSITS

Under FDIC regulations, no FDIC-insured depository institution can accept brokered deposits unless it (i) is well capitalized, or (ii) is adequately capitalized and received a waiver from the FDIC. In addition, these regulations prohibit any depository institution that is not well capitalized from (a) paying an interest rate on deposits in excess of 76 basis points over certain prevailing market rates or (b) offering "pass through" deposit insurance on certain employee

benefit plan accounts unless it provides certain notice to affected depositors.

#### INTERSTATE BANKING AND BRANCHING

Under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (“Riegle-Neal”), subject to certain concentration limits, required regulatory approvals and other requirements, (i) financial holding companies such as the Corporation are permitted to acquire banks and bank holding companies located in any state; (ii) any bank that is a subsidiary of a bank holding company is permitted to receive deposits, renew time deposits, close loans, service loans and receive loan payments as an agent for any other bank subsidiary of that holding company; and (iii) banks are permitted to acquire branch offices outside their home states by merging with out-of-state banks, purchasing branches in other states, and establishing de novo branch offices in other states.

#### FINANCIAL SERVICES MODERNIZATION ACT

The Gramm-Leach-Bliley Act of 1999 (the “Financial Services Modernization Act”) establishes a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the existing BHC Act. Under this legislation, bank holding companies would be permitted to conduct essentially unlimited securities and insurance activities as well as other activities determined by the Federal Reserve Board to be financial in nature or related to financial services. As a result, the Corporation is able to provide securities and insurance services. Furthermore, under this legislation, the Corporation is able to acquire, or be acquired, by brokerage and securities firms and insurance underwriters. In addition, the Financial Services Modernization Act broadens the activities that may be conducted by national banks through the formation of financial subsidiaries. Finally, the Financial Services Modernization Act modifies the laws governing the implementation of the Community Reinvestment Act and addresses a variety of other legal and regulatory issues affecting both day-to-day operations and long-term activities of financial institutions.

Table of Contents

PART I: ITEM 1. BUSINESS

A bank holding company may become a financial holding company if each of its subsidiary banks is well capitalized, is well managed and has at least a satisfactory rating under the Community Reinvestment Act, by filing a declaration that the bank holding company wishes to become a financial holding company. Also effective March 11, 2000, no regulatory approval is required for a financial holding company to acquire a company, other than a bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve Board. The Federal Reserve Bank of Chicago approved the Corporation's application to become a Financial Holding Company effective September 13, 2000.

USA PATRIOT ACT

As part of the USA Patriot Act, signed into law on October 26, 2001, Congress adopted the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (the "Act"). The Act authorizes the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to financial institutions such as banks, bank holding companies, broker-dealers and insurance companies. Among its other provisions, the Act requires each financial institution: (i) to establish an anti-money laundering program; (ii) to establish due diligence policies, procedures and controls that are reasonably designed to detect and report instances of money laundering in United States private banking accounts and correspondent accounts maintained for non-United States persons or their representatives; and (iii) to avoid establishing, maintaining, administering, or managing correspondent accounts in the United States for, or on behalf of, a foreign shell bank that does not have a physical presence in any country. In addition, the Act expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours.

Treasury regulations implementing the due diligence requirements were issued in 2002. These regulations required minimum standards to verify customer identity, encouraged cooperation among financial institutions, federal banking agencies, and law enforcement authorities regarding possible money laundering or terrorist activities, prohibited the anonymous use of "concentration accounts," and required all covered financial institutions to have in place an anti-money laundering compliance program.

The Act also amended the Bank Holding Company Act and the Bank Merger Act to require the federal banking agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing an application under these acts.

THE SARBANES-OXLEY ACT

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), which became law on July 30, 2002, added new legal requirements for public companies affecting corporate governance, accounting and corporate reporting. The Sarbanes-Oxley Act provides for, among other things:

- a prohibition on personal loans made or arranged by the issuer to its directors and executive officers (except for loans made by a bank subject to Regulation O);
- independence requirements for audit committee members;
- independence requirements for company auditors;
- certification of financial statements on Forms 10-K and 10-Q reports by the chief executive officer and the chief financial officer;
- the forfeiture by the chief executive officer and chief financial officer of bonuses or other incentive-based compensation and profits from the sale of an issuer's securities by such officers in the twelve-month period following

initial publication of any financial statements that later require restatement due to corporate misconduct;

- disclosure of off-balance sheet transactions;
- two-business day filing requirements for insiders filing Form 4s;
- disclosure of a code of ethics for financial officers and filing a Form 8-K for a change in or waiver of such code;
- the reporting of securities violations “up the ladder” by both in-house and outside attorneys;
- restrictions on the use of non-GAAP financial measures in press releases and SEC filings;
- the formation of a public accounting oversight board; and
- various increased criminal penalties for violations of securities laws.

The Sarbanes-Oxley Act contains provisions, which became effective upon enactment on July 30, 2002, including provisions, which became effective from within 30 days to one year from enactment. The SEC has been delegated the task of enacting rules to implement various provisions. In addition, each of the national stock exchanges developed new corporate governance rules, including rules strengthening director independence requirements for boards, the adoption of corporate governance codes and charters for the nominating, corporate governance and audit committees.

#### ADDITIONAL MATTERS

The Corporation and the Bank are subject to the Federal Reserve Act, which restricts financial transactions between banks and affiliated companies. The statute limits credit transactions between banks, affiliated companies and its executive officers and its affiliates. The statute prescribes terms and conditions for bank affiliate transactions deemed to be consistent with safe and sound banking practices. It also restricts the types of collateral security permitted in connection with the bank’s extension of credit to an affiliate. Additionally, all transactions with an affiliate must be on terms substantially the same or at least as favorable to the institution as those prevailing at the time for comparable transactions with non-affiliated parties.



Table of Contents

PART I: ITEM 1. BUSINESS

In addition to the matters discussed above, the Bank is subject to additional regulation of its activities, including a variety of consumer protection regulations affecting its lending, deposit and collection activities and regulations affecting secondary mortgage market activities.

The earnings of financial institutions are also affected by general economic conditions and prevailing interest rates, both domestic and foreign, and by the monetary and fiscal policies of the United States Government and its various agencies, particularly the Federal Reserve. The Federal Reserve regulates the supply of credit in order to influence general economic conditions, primarily through open market operations in United States Government obligations, varying the discount rate on financial institution borrowings, varying reserve requirements against financial institution deposits, and restricting certain borrowings by financial institutions and their subsidiaries. The monetary policies of the Federal Reserve have had a significant effect on the operating results of the Bank in the past and are expected to continue to do so in the future.

Additional legislation and administrative actions affecting the banking industry may be considered by the United States Congress, state legislatures and various regulatory agencies, including those referred to above. It cannot be predicted with certainty whether such legislation or administrative action will be enacted or the extent to which the banking industry, the Corporation or the Bank would be affected.

Table of Contents

## PART I: ITEM 1. BUSINESS

## STATISTICAL DATA

The following tables set forth statistical data on the Corporation and its subsidiaries.

## DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY; INTEREST RATES AND INTEREST DIFFERENTIAL

The daily average balance sheet amounts, the related interest income or interest expense, and average rates earned or paid are presented in the following table:

	Average Balance	Interest Income / Expense	Average Rate	Average Balance	Interest Income / Expense	Average Rate	Average Balance	Interest Income / Expense	Average Rate
(Dollars in Thousands)	2014			2013			2012		
Assets:									
Interest-bearing deposits	\$53,231	\$124	0.2 %	\$74,964	\$158	0.2 %	\$57,842	\$100	0.2 %
Federal reserve and federal home loan bank stock	42,142	2,124	5.0	33,620	1,488	4.4	32,819	1,408	4.3
Securities: <sup>(1)</sup>									
Taxable	763,450	19,882	2.6	617,524	15,214	2.5	670,973	17,027	2.5
Tax-Exempt <sup>(2)</sup>	396,435	22,127	5.6	282,584	16,660	5.9	251,724	15,675	6.2
Total securities	1,159,885	42,009	3.6	900,108	31,874	3.5	922,697	32,702	3.5
Loans held for sale	6,681	485	7.3	16,137	770	4.8	20,648	1,024	5.0
Loans: <sup>(3)</sup>									
Commercial	2,919,020	133,567	4.6	2,391,221	113,613	4.8	2,166,238	114,078	5.3
Real estate mortgage	429,384	19,812	4.6	277,520	12,375	4.5	293,384	13,848	4.7
Installment	361,484	18,175	5.0	308,233	15,994	5.2	324,553	17,795	5.5
Tax-Exempt <sup>(2)</sup>	13,511	504	3.7	15,444	605	3.9	14,993	739	4.9
Total loans	3,730,080	172,543	4.6	3,008,555	143,357	4.8	2,819,816	147,484	5.2
Total earning assets	4,985,338	216,800	4.3 %	4,017,247	176,877	4.4 %	3,833,174	181,694	4.7 %
Net unrealized gain on securities available for sale	8,921			4,521			16,116		
Allowance for loan losses	(67,969 )			(68,806 )			(71,038 )		
Cash and due from banks	87,068			73,161			66,109		
Premises and equipment	75,202			57,228			51,692		
Other assets	482,794			372,060			349,943		
Total assets	\$5,571,354			\$4,455,411			\$4,245,996		
Liabilities:									
Interest-bearing deposits:									
NOW accounts	\$1,066,402	\$1,110	0.1 %	\$880,323	\$941	0.1 %	\$814,831	\$1,007	0.1 %

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Money market deposit accounts	776,712	1,572	0.2	603,012	1,287	0.2	501,537	1,370	0.3
Savings deposits	533,080	619	0.1	377,106	421	0.1	327,644	528	0.2
Certificates and other time deposits	1,042,539	8,377	0.8	807,764	7,404	0.9	935,713	11,895	1.3
Total interest-bearing deposits	3,418,733	11,678	0.3	2,668,205	10,053	0.4	2,579,725	14,800	0.6
Borrowings	492,128	10,164	2.1	400,580	6,516	1.6	411,915	8,813	2.1
Total interest-bearing liabilities	3,910,861	21,842	0.6	3,068,785	16,569	0.5	2,991,640	23,613	0.8
Noninterest-bearing deposits	945,222			797,435			683,295		
Other liabilities	39,976			48,936			35,564		
Total liabilities	4,896,059			3,915,156			3,710,499		
Stockholders' Equity	675,295			540,255			535,497		
Total Liabilities and Stockholders' Equity	\$5,571,354	21,842	0.4	\$4,455,411	16,569	0.4	\$4,245,996	23,613	0.6
Net Interest Income		\$194,958			\$160,308			\$158,081	
Net Interest Margin			3.9 %			4.0 %			4.1 %

---

(1) Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustment.

(2) Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 35 percent for 2014, 2013 and 2012. These totals equal \$7,921, \$6,043 and \$5,745, respectively.

(3) Non-accruing loans have been included in the average balances.

Table of Contents

## PART I: ITEM 1. BUSINESS

## ANALYSIS OF CHANGES IN NET INTEREST INCOME

The following table presents net interest income components on a tax-equivalent basis and reflects changes between periods attributable to movement in either the average balance or average interest rate for both earning assets and interest-bearing liabilities. The volume differences were computed as the difference in volume between the current and prior year multiplied by the interest rate from the prior year. The interest rate changes were computed as the difference in rate between the current and prior year multiplied by the volume from the prior year. Volume/rate variances have been allocated on the basis of the absolute relationship between volume variances and rate variances.

(Dollars in Thousands, Fully Taxable Equivalent Basis)	2014 Compared to 2013 Increase (Decrease) Due To			2013 Compared to 2012 Increase (Decrease) Due To			2012 Compared to 2011 Increase (Decrease) Due To		
	Volume	Rate	Total	Volume	Rate	Total	Volume	Rate	Total
<b>Interest Income:</b>									
Federal funds sold									
Interest-bearing deposits	\$(49 )	\$15	\$(34 )	\$33	\$25	\$58	\$(3 )		\$(3 )
Federal Reserve and Federal Home Loan Bank stock	411	225	636	35	45	80	17	72	89
Securities	9,393	742	10,135	(800 )	(28 )	(828 )	1,222	(3,392 )	(2,170 )
Mortgage loans held for sale	(576 )	291	(285 )	(216 )	(38 )	(254 )	575	(105 )	470
Loans	33,894	(4,423 )	29,471	9,718	(13,591 )	(3,873 )	3,226	(6,740 )	(3,514 )
Totals	43,073	(3,150 )	39,923	8,770	(13,587 )	(4,817 )	4,997	(10,307 )	(5,310 )
<b>Interest Expense:</b>									
NOW accounts	194	(25 )	169	77	(143 )	(66 )	72	(518 )	(446 )
Money market deposit accounts	354	(69 )	285	248	(331 )	(83 )	101	(288 )	(187 )
Savings deposits	180	18	198	72	(179 )	(107 )	64	(204 )	(140 )
Certificates and other time deposits	1,966	(993 )	973	(1,477 )	(3,014 )	(4,491 )	(1,624 )	(5,084 )	(6,708 )
Borrowings	1,673	1,975	3,648	(237 )	(2,060 )	(2,297 )	(1,370 )	(5,426 )	(6,796 )
Totals	4,367	906	5,273	(1,317 )	(5,727 )	(7,044 )	(2,757 )	(11,520 )	(14,277 )
Change in net interest income (fully taxable equivalent basis)	\$38,706	\$(4,056)	34,650	\$10,087	\$(7,860)	2,227	\$7,754	\$1,213	8,967
Tax equivalent adjustment using marginal rate of 35% for 2014, 2013, and 2012			(1,878 )			(298 )			14
Change in net interest income			\$32,772			\$1,929			\$8,981

## INVESTMENT SECURITIES

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities are generally evaluated for OTTI under Accounting Standards Codification (“ASC”) 320,

Investments – Debt and Equity Securities. However, certain purchased beneficial interest, including certain non-agency government-sponsored mortgage-backed securities, asset-backed securities and collateralized debt obligations are evaluated using the model outlined in ASC 325-10, Investments - Other.

In determining OTTI under ASC 320, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Corporation has the intent to sell the debt security or more likely than not, will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of OTTI recognized in the income statement depends on whether the Corporation intends to sell the security or it is more likely than not that the Corporation will be required to sell the security before recovery of its amortized cost basis, less any recognized credit loss. If the intent is to sell, or it is more likely than not that the Corporation will be required to sell the security before recovery of its amortized cost basis, less any recognized credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis, less any recognized credit loss, and its fair value at the balance sheet date. If the intent is not to sell the security and it is not more likely than not that the Corporation will be required to sell the security before the recovery of its amortized cost basis less any recognized credit loss, the OTTI has been separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors has been recognized in other comprehensive income, net of applicable income taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

The Corporation's management has evaluated all securities with unrealized losses for OTTI as of December 31, 2014. The evaluations are based on the nature of the securities, the extent and duration of the loss and the intent and ability of the Corporation to hold these securities either to maturity or through the expected recovery period.

Table of Contents

## PART I: ITEM 1. BUSINESS

In determining the fair value of the investment securities portfolio, the Corporation utilizes a third party for portfolio accounting services, including market value input, for those securities classified as Level I and Level II in the fair value hierarchy. The Corporation has obtained an understanding of what inputs are being used by the vendor in pricing the portfolio and how the vendor classified these securities based upon these inputs. From these discussions, the Corporation's management is comfortable that the classifications are proper. The Corporation has gained trust in the data for two reasons: (a) independent spot testing of the data is conducted by the Corporation through obtaining market quotes from various brokers on a periodic basis; and (b) actual gains or loss resulting from the sale of certain securities has proven the data to be accurate over time. Fair value of securities classified as Level 3 in the valuation hierarchy were determined using a discounted cash flow model that incorporated market estimates of interest rates and volatility in markets that have not been active.

The Corporation continues to evaluate the portfolio for OTTI on an ongoing basis. In 2014, the Corporation sold all but one of its trust preferred securities, which resulted in gains of \$1.9 million. These securities had previous OTTI of \$9.4 million. The one remaining trust preferred security has no remaining book value as a result of OTTI of approximately \$500,000 taken in 2009.

The amortized cost, gross unrealized gains, gross unrealized losses and approximate market value of the investment securities at the dates indicated were:

(Dollars in Thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2014				
U.S. Government-sponsored agency securities	\$ 100	\$9		\$ 109
State and municipal	216,915	11,801	\$123	228,593
U.S. Government-sponsored mortgage-backed securities	310,460	8,771	127	319,104
Corporate obligations	31			31
Equity securities	1,706			1,706
Total available for sale	529,212	20,581	250	549,543
Held to maturity at December 31, 2014				
State and municipal	204,443	5,716	96	210,063
U.S. Government-sponsored mortgage-backed securities	426,645	11,527	512	437,660
Total held to maturity	631,088	17,243	608	647,723
Total Investment Securities	\$ 1,160,300	\$37,824	\$ 858	\$ 1,197,266
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2013				
U.S. Treasury	\$ 15,914	\$80	\$21	\$ 15,973
U.S. Government-sponsored agency securities	3,550	12	17	3,545
State and municipal	231,005	3,878	3,896	230,987
U.S. Government-sponsored mortgage-backed securities	279,299	3,926	1,973	281,252
Corporate obligations	6,374		3,636	2,738
Equity securities	1,706			1,706
Total available for sale	537,848	7,896	9,543	536,201
Held to maturity at December 31, 2013				

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

State and municipal	145,941	62	91	145,912
U.S. Government-sponsored mortgage-backed securities	413,437	5,220	3,722	414,935
Total held to maturity	559,378	5,282	3,813	560,847
Total Investment Securities	\$1,097,226	\$13,178	\$13,356	\$1,097,048

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2012				
U.S. Government-sponsored agency securities	\$4,475	\$165		\$4,640
State and municipal	148,187	10,025	\$18	158,194
U.S. Government-sponsored mortgage-backed securities	337,631	10,994	46	348,579
Corporate obligations	6,105		5,881	224
Equity securities	1,706			1,706
Total available for sale	498,104	21,184	5,945	513,343
Held to maturity at December 31, 2012				
State and municipal	117,227	5,489	1	122,715
U.S. Government-sponsored mortgage-backed securities	243,793	11,681	15	255,459
Total held to maturity	361,020	17,170	16	378,174
Total Investment Securities	\$859,124	\$38,354	\$5,961	\$891,517

Table of Contents

## PART I: ITEM 1. BUSINESS

The cost and yields for Federal Reserve and Federal Home Loan Bank stock are included in the table below.

(Dollars in Thousands)	2014		2013		2012	
	Cost	Yield	Cost	Yield	Cost	Yield
Federal Reserve and Federal Home Loan Bank stock at December 31:						
Federal Reserve Bank stock	\$18,949	6.0 %	\$13,287	6.0 %	\$13,261	6.0 %
Federal Home Loan Bank stock	22,404	5.1 %	25,703	2.0 %	19,524	2.0 %
Total	\$41,353	5.5 %	\$38,990	3.4 %	\$32,785	3.6 %

Federal Reserve and Federal Home Loan Bank stock have been reviewed for impairment and the analysis reflected no impairment. The Corporation's Federal Home Loan Bank stock is primarily in the Federal Home Loan Bank of Indianapolis and it continued to produce sufficient financial results to pay dividends.

There were no issuers included in the investment security portfolio at December 31, 2014, 2013 or 2012 where the aggregate carrying value of any one issuer exceeded 10 percent of the Corporation's stockholders' equity at those dates. The term "issuer" excludes the U.S. Government and its sponsored agencies and corporations.

The maturity distribution and average yields for the securities portfolio at December 31, 2014 were:

(Dollars in Thousands)	Within 1 Year		1-5 Years		5-10 Years	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
Securities available for sale December 31, 2014						
U.S. Government-sponsored agency securities			\$109	4.9 %		
State and municipal	\$3,122	5.0 %	9,731	5.3 %	\$50,889	5.5 %
Corporate obligations	31	0.0 %				
	\$3,153	5.0 %	\$9,840	5.3 %	\$50,889	5.5 %
			Equity and U.S. Government-Sponsored Mortgage - Backed Securities		Total	
	Due After Ten Years		Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
U.S. Government-sponsored agency securities					\$109	4.9 %
State and municipal	\$164,851	5.3 %			228,593	5.3 %
Equity securities			\$1,706	1.8 %	1,706	1.8 %
Corporate obligations					31	— %
U.S. Government-sponsored mortgage-backed securities			319,104	2.9 %	319,104	2.9 %
	\$164,851	5.3 %	\$320,810	2.9 %	\$549,543	3.9 %



Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

	Within 1 Year Amount	Yield <sup>(1)</sup>		1-5 Years Amount	Yield <sup>(1)</sup>		5-10 Years Amount	Yield <sup>(1)</sup>
Securities held to maturity at December 31, 2014								
State and municipal	\$6,258	3.2	%	\$18,440	4.4	%	\$85,997	6.1
U.S. Government-sponsored mortgage-backed securities	\$6,258	3.2	%	\$18,440	4.4	%	\$85,997	6.1
	Due After Ten Years			Equity and U.S. Government- Sponsored Mortgage - Backed Securities			Total	
	Amount	Yield <sup>(1)</sup>		Amount	Yield <sup>(1)</sup>		Amount	Yield <sup>(1)</sup>
State and municipal	\$93,748	5.2	%				\$204,443	5.4
U.S. Government-sponsored mortgage-backed securities				\$426,645	2.9	%	426,645	2.9
	\$93,748	5.2	%	\$426,645	2.9	%	\$631,088	3.7

---

(1) Interest yields are presented on a fully taxable equivalent basis using a 35 percent tax rate.

Table of Contents

## PART I: ITEM 1. BUSINESS

The following tables show the Corporation's gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2014 and 2013:

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Available for Sale Securities at December 31, 2014						
State and municipal	\$1,256	\$7	\$9,850	\$116	\$11,106	\$123
U.S. Government-sponsored mortgage-backed securities	2,186	13	5,447	114	7,633	127
Total temporarily impaired available for sale securities	3,442	20	15,297	230	18,739	250
Temporarily Impaired Held to Maturity Securities at December 31, 2014						
State and municipal	5,119	96	250		5,369	96
U.S. Government-sponsored mortgage-backed securities	9,791	82	38,491	430	48,282	512
Total temporarily impaired held to maturity securities	14,910	178	38,741	430	53,651	608
Total temporarily impaired investment securities	\$18,352	\$198	\$54,038	\$660	\$72,390	\$858

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Available for Sale Securities at December 31, 2013						
U.S. Treasury	\$4,875	\$21			\$4,875	\$21
U.S. Government-sponsored agency securities	3,433	17			3,433	17
State and municipal	111,791	3,840	\$583	\$56	112,374	3,896
U.S. Government-sponsored mortgage-backed securities	117,866	1,701	2,683	272	120,549	1,973
Corporate obligations			2,711	3,636	2,711	3,636
Total Temporarily Impaired Available for Sale Securities	237,965	5,579	5,977	3,964	243,942	9,543
Temporarily Impaired Held to Maturity Securities at December 31, 2013						
State and municipal	17,318	91	184		17,502	91
U.S. Government-sponsored mortgage-backed securities	213,048	3,462	2,640	260	215,688	3,722
	230,366	3,553	2,824	260	233,190	3,813

Total temporarily impaired held to maturity securities

Total temporarily impaired investment securities	\$468,331	\$9,132	\$8,801	\$4,224	\$477,132	\$13,356
--	-----------	---------	---------	---------	-----------	----------

Table of Contents

## PART I: ITEM 1. BUSINESS

## LOAN PORTFOLIO

The following table shows the composition of the Corporation's loan portfolio for the years indicated:

(Dollars in Thousands)	2014		2013		2012		2011		2010	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Loans at December 31:										
Commercial and industrial loans	\$896,688	22.8	% \$761,705	21.0	% \$622,579	21.5	% \$532,523	19.6	% \$530,322	18.7
Agricultural production financing and other loans to farmers	104,927	2.7	114,348	3.1	112,527	3.9	104,526	3.9	95,516	3.4
Real estate loans:										
Construction	207,221	5.3	177,082	4.9	98,639	3.4	81,780	3.0	106,615	3.8
Commercial and farmland	1,672,661	42.6	1,611,809	44.4	1,266,682	43.6	1,194,230	44.0	1,229,037	43.3
Residential	647,315	16.5	616,385	17.0	473,537	16.3	481,493	17.7	522,051	18.4
Home equity	286,529	7.3	255,223	7.0	203,406	7.0	191,631	7.1	201,969	7.1
Individuals' loans for household and other personal expenditures	73,400	1.9	69,783	1.9	75,748	2.6	84,172	3.1	115,295	4.1
Lease financing receivables, net of unearned income	1,106		1,545		2,590	0.1	3,555	0.1	5,157	0.2
Other loans	35,018	0.9	24,529	0.7	46,501	1.6	39,505	1.5	29,721	1.0
Loans	3,924,865	100.0	% 3,632,409	100.0	% 2,902,209	100.0	% 2,713,415	100.0	% 2,835,683	100.0
Allowance for loan losses	(63,964 )		(67,870 )		(69,366 )		(70,898 )		(82,977 )	
Net Loans	\$3,860,901		\$3,564,539		\$2,832,843		\$2,642,517		\$2,752,706	

Residential Real Estate Loans Held for Sale at December 31, 2014, 2013, 2012, 2011 and 2010 were \$7,235,000, \$5,331,000, \$22,300,000, \$17,864,000, and \$21,469,000, respectively.

The Bank acquired \$113.0 million of loans at a fair value discount of \$19.2 million as part of the February 10, 2012 SCB transaction. The November 12, 2013 CFS acquisition included loans of \$639.6 million and a fair value discount of \$36.5 million. The assets acquired in the November 7, 2014 Community transaction included \$153.9 million in loans which were acquired at a fair value discount of \$8.8 million. Loans evidencing deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected are included in the above table.

The majority of the Corporation's portfolio is comprised of loans secured by commercial and farmland real estate, commercial and industrial loans and loans secured by residential real estate. Commercial and farmland real estate loans made up 42.6 percent and 44.4 percent of loans at December 31, 2014 and 2013, respectively. Commercial and industrial loans made up 22.8 percent and 21.0 percent of loans and residential real estate loans, including home equity, made up 23.8 percent and 24.0 percent of loans at December 31, 2014 and 2013, respectively. The Bank generates loans from customers primarily in central and northwest Indiana, northeast Illinois and central Ohio. The Bank's loans are generally secured by specific items of collateral, including real property, consumer assets, and business assets.

#### LOAN MATURITIES

Presented in the table below are the maturities of loans (excluding residential real estate, home equity, individuals' loans for household and other personal expenditures and lease financing) outstanding as of December 31, 2014. Also presented are the amounts due after one year, classified according to the sensitivity to changes in interest rates.

(Dollars in Thousands)	Maturing Within 1 Year	Maturing 1-5 Years	Maturing Over 5 Years	Total
Commercial and industrial loans	\$664,359	\$166,593	\$65,736	\$896,688
Agriculture production financing and other loans to farmers	87,738	16,334	855	104,927
Real estate loans:				
Construction	188,337	14,819	4,065	207,221
Commercial and farmland	651,626	797,429	223,606	1,672,661
Other loans	5,778	10,529	18,711	35,018
Total	\$1,597,838	\$1,005,704	\$312,973	\$2,916,515

(Dollars in Thousands)	Maturing 1-5 Years	Maturing Over 5 Years
Loans maturing after one year with:		
Fixed rate	\$668,215	\$275,248
Variable rate	337,489	37,725
Total	\$1,005,704	\$312,973

Table of Contents

## PART I: ITEM 1. BUSINESS

## NON-PERFORMING ASSETS

The table below summarizes non-performing assets and impaired loans for the years indicated:

(Dollars in Thousands)	December 31, 2014	December 31, 2013	December 31, 2012	December 31, 2011	December 31, 2010
Non-Performing Assets:					
Non-accrual loans	\$48,789	\$56,402	\$53,399	\$69,592	\$90,591
Renegotiated loans	1,992	3,048	12,681	14,308	7,139
Non-performing loans (NPL)	50,781	59,450	66,080	83,900	97,730
Other real estate owned	19,293	22,246	13,263	16,289	20,927
Non-performing assets (NPA)	70,074	81,696	79,343	100,189	118,657
90+ days delinquent and still accruing	4,663	1,350	2,037	580	1,330
NPAs & 90+ days delinquent	\$74,737	\$83,046	\$81,380	\$100,769	\$119,987
Impaired loans	\$116,223	\$119,755	\$79,179	\$79,775	\$116,204

Loans are reclassified to a non-accruing status when, in management's judgment, the collateral value and financial condition of the borrower do not justify accruing interest. Interest previously recorded, but not deemed collectible, is reversed and charged against current income. Payments subsequently received on non-accrual loans are applied to principal.

At December 31, 2014, non-accrual loans and other real estate owned of \$48,789,000 and \$19,293,000 include assets acquired from Community of \$5,674,000 and \$6,662,000, respectively. At December 31, 2013, non-accrual loans and other real estate owned of \$56,402,000 and \$22,246,000 include assets acquired from CFS of \$22,703,000 and \$12,889,000, respectively. At December 31, 2012, non-accrual loans and other real estate owned of \$53,399,000 and \$13,263,000 include assets acquired from SCB of \$4,219,000 and \$160,000, respectively.

Renegotiated loans are loans for which concessions are granted to the borrower due to deterioration in the financial condition of the borrower, resulting in the inability of the borrower to meet the original contractual terms of the loans. These concessions may include interest rate reductions, principal forgiveness, extensions of maturity date or other actions intended to minimize losses. Certain loans restructured may be excluded from restructured loan disclosures in years subsequent to the restructuring if the loans are in compliance with their modified terms. A non-accrual loan that is restructured may remain non-accrual for a period of approximately six months until the borrower can demonstrate their ability to meet the restructured terms. A borrower's performance prior to the restructuring, as well as after, will be considered in assessing whether the borrower can meet the new terms resulting in the loan being returned to accruing status in a shorter or longer period of time than the standard six months. If the borrower's performance under the modified terms is not reasonably assured, the loan will remain non-accrual.

For the year ended December 31, 2014, interest income of \$1,488,000 was recognized on the non-accruing and renegotiated loans listed in the table above, whereas interest income of \$6,127,000 would have been recognized under their original loan terms.

At December 31, 2014, the commercial impaired loan total of \$116,223,000 included \$17,027,000 in loans acquired from Community. At December 31, 2013, the commercial impaired loan total of \$119,755,000 included \$69,448,000 in loans acquired from CFS. At December 31, 2012, the commercial impaired loan total of \$79,179,000 included

\$17,334,000 in loans acquired from SCB. Commercial impaired loans include all non-accrual loans, loans accounted for under ASC 310 as well as substandard, doubtful and loss grade loans that were still accruing but deemed impaired according to guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more and troubled debt restructurings. A loan is deemed impaired under ASC 310 when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected. A specific allowance for losses was not deemed necessary for a subset of the impaired loans totaling \$102,793,000, but a specific allowance of \$2,769,000 was recorded for the remaining balance of \$13,430,000 and is included in the Corporation's allowance for loan losses at December 31, 2014. A specific allowance totaling \$650,000 was recorded on loans acquired from CFS with deteriorated credit quality in 2013, while no specific allowance was recorded on loans acquired with deteriorated credit quality from SCB in 2012 or Community in 2014. The average balance of the aforementioned total impaired loans for 2014 was \$122,571,000.

Allowable methods for determining the amount of impairment include estimating fair value using the fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. The fair value of real estate is generally based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically ascertained by assessing, either singularly or some combination of, asset appraisals, accounts receivable aging reports, inventory listings and or customer financial statements. Both appraised values and values based on borrower's financial information are discounted as considered appropriate based on age and quality of the information and current market conditions.

In addition to the impaired loans discussed above, management also identified loans totaling \$161,860,000 as of December 31, 2014 that were deemed to be criticized, but not impaired. These loans are not included in the table above, or the impaired loan table in the footnotes to the consolidated financial statements. A criticized loan is a loan in which there are concerns as to the borrower's ability to comply with present repayment terms, whether or not those concerns rise to the level of serious doubt.

See additional information regarding loan credit quality in Note 6. LOANS AND ALLOWANCE, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

Table of Contents

## PART I: ITEM 1. BUSINESS

## SUMMARY OF LOAN LOSS EXPERIENCE

The following table summarizes the loan loss experience for the years indicated:

(Dollars in Thousands)	2014	2013	2012	2011	2010	
Allowance for loans losses:						
Balances, January 1	\$67,870	\$69,366	\$70,898	\$82,977	\$92,131	
Charge offs:						
Commercial <sup>(1)</sup>	7,246	6,117	8,311	9,818	22,832	
Commercial real estate <sup>(2)</sup>	6,608	7,493	12,322	29,807	32,823	
Consumer	657	623	1,130	1,441	2,426	
Residential	2,869	3,886	5,475	7,407	9,437	
Finance leases	2	15	34		54	
Total Charge Offs	17,382	18,134	27,272	48,473	67,572	
Recoveries:						
Commercial <sup>(3)</sup>	5,435	4,586	1,744	8,828	6,750	
Commercial real estate <sup>(4)</sup>	3,297	3,552	3,652	2,811	1,420	
Consumer	377	556	695	942	938	
Residential	1,783	1,292	1,113	1,176	2,827	
Finance leases	24	4	2	7		
Total Recoveries	10,916	9,990	7,206	13,764	11,935	
Net charge offs	6,466	8,144	20,066	34,709	55,637	
Provisions for loan losses	2,560	6,648	18,534	22,630	46,483	
Balance at December 31	\$63,964	\$67,870	\$69,366	\$70,898	\$82,977	
Ratio of net charge offs during the period to average loans outstanding during the period	0.17	% 0.27	% 0.71	% 1.26	% 1.82	%

See the information regarding the analysis of loan loss experience in the “Provision and Allowance for Loan Losses” section of Management’s Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.



---

(1) Category includes the charge offs for commercial and industrial, agricultural production financing and other loans to farmers and other non-consumer loans.

(2) Category includes the charge offs for construction, commercial and farmland.

(3) Category includes the recoveries for commercial and industrial, agricultural production financing and other loans to farmers and other non-consumer loans.

(4) Category includes the recoveries for construction, commercial and farmland.

18

---

Table of Contents

## PART I: ITEM 1. BUSINESS

## ALLOCATION OF THE ALLOWANCE FOR LOAN LOSSES

Presented below is an analysis of the composition of the allowance for loan losses and percent of loans in each category to total loans as of December 31, 2014, 2013, 2012, 2011 and 2010.

(Dollars in Thousands)	2014		2013		2012		2011		2010	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Balance at December 31:										
Commercial	\$28,824	26.4 %	\$27,176	24.8 %	\$25,913	26.9 %	\$17,731	24.9 %	\$32,508	23.1 %
Commercial real estate	19,327	47.9	23,102	49.3	26,703	47.1	37,919	47.1	36,341	47.1
Consumer	2,658	1.9	2,515	1.9	2,593	2.6	2,902	3.1	3,622	4.1
Residential	13,152	23.8	15,077	24.0	14,157	23.3	12,343	24.8	10,408	25.5
Finance leases	3					0.1	3	0.1	98	0.2
Totals	\$63,964	100.0 %	\$67,870	100.0 %	\$69,366	100.0 %	\$70,898	100.0 %	\$82,977	100.0 %

Loan concentrations are considered to exist when there are amounts loaned to multiple borrowers engaged in similar activities, which would cause them to be similarly impacted by economic or other conditions. As of December 31, 2014, the only concentrations of commercial loans within a single industry (as segregated by North American Industry Classification System (“NAICS code”)) in excess of 10 percent of loans were Lessors of Nonresidential Buildings and Lessors of Residential Buildings and Dwellings.

## LOAN LOSS CHARGE OFF PROCEDURES

The Corporation maintains an allowance for loan losses to cover probable credit losses identified during its loan review process. The allowance is increased by the provision for loan losses and decreased by charge offs less recoveries. All charge offs are approved by the Bank’s senior loan officers or loan committees, depending on the amount of the charge off, and are reported to the Bank’s Board of Directors. The Bank charges off loans when a determination is made that all or a portion of a loan is uncollectible.

## PROVISION FOR LOAN LOSSES

In banking, loan losses are a cost of doing business. Although Bank management emphasizes the early detection and charge off of loan losses, it is inevitable that certain losses, which have not been specifically identified, exist in the portfolio. Accordingly, the provision for loan losses is charged to earnings on an anticipatory basis, and recognized loan losses net of recoveries are deducted from the established allowance. Over time, all net loan losses are charged to earnings. During the year, an estimate of the expected losses for the year serves as a starting point in determining the appropriate level of the provision for loan losses. Based on management’s judgment as to the appropriate level of the allowance for loan losses the amount actually provided in any period may be greater or less than net loan losses for the same period. The determination of the provision for loan losses in any period is based on management’s continuing review and evaluation of the loan portfolio, and its judgment as to the impact of current economic conditions on the portfolio. The evaluation by management includes consideration of past loan loss experience, changes in the composition of the loan portfolio, and the current condition and amount of loans outstanding. See additional information in the “Provision and Allowance For Loan Losses” section of Management’s Discussion and Analysis of

Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

## DEPOSITS

The average balances, interest expense and average rates on deposits for the years ended December 2014, 2013 and 2012 are presented in the Part I. Item I. Business section titled "DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY, INTEREST RATES AND INTEREST DIFFERENTIAL" of this Annual Report on Form 10-K.

As of December 31, 2014, certificates of deposit and other time deposits of \$100,000 or more mature as follows:

(Dollars in Thousands)	Maturing 3 Months or Less	Maturing 3-6 Months	Maturing 6-12 Months	Maturing Over 12 Months	Total	
Certificates of deposit and other time deposits	\$50,767	\$33,463	\$60,380	\$116,075	\$260,685	
Percent	19	% 13	% 23	% 45	% 100	%

## RETURN ON EQUITY AND ASSETS

See the information regarding return on equity and assets presented within Part II: Item 6. SELECTED FINANCIAL DATA of this Annual Report on Form 10-K.

Table of Contents

## PART I: ITEM 1. BUSINESS

## SHORT-TERM BORROWINGS

Borrowings maturing in one year or less are included in the following table:

(Dollars in Thousands)	2014	2013	2012
Balance at December 31:			
Federal funds purchased	\$15,381	\$125,645	\$18,862
Securities sold under repurchase agreements (short-term portion)	124,539	148,672	131,828
Federal Home Loan Bank advances (short-term portion)	30,701	26,272	1,434
Subordinated debentures and term loans (short-term portion)	108	105	459
Total short-term borrowings	\$170,729	\$300,694	\$152,583

Securities sold under repurchase agreements are categorized as borrowings maturing within one year and are secured by U.S. Treasury and U.S. Government-Sponsored Enterprise obligations, certain municipal securities and mortgage loans.

Pertinent information with respect to short-term borrowings is summarized below:

(Dollars in Thousands)	2014	2013	2012	
Weighted Average Interest Rate on Outstanding Balance at December 31:				
Federal funds purchased	0.3	% 0.3	% 0.2	%
Securities sold under repurchase agreements (short-term portion)	0.3	% 0.5	% 0.2	%
Federal Home Loan Bank advances (short-term portion)	2.0	% 1.1	% 2.0	%
Subordinated debentures and term loans (short-term portion)				
Total short-term borrowings	0.6	% 0.5	% 0.2	%
Weighted Average Interest Rate During the Year:				
Federal funds purchased	0.4	% 0.4	% 0.3	%
Securities sold under repurchase agreements (short-term portion)	0.4	% 0.6	% 0.3	%
Federal Home Loan Bank advances (short-term portion)	0.9	% 0.8	% 3.4	%
Subordinated debentures and term loans (short-term portion)			2.9	%
Total short-term borrowings	0.6	% 0.6	% 0.9	%
Highest Amount Outstanding at Any Month End During the Year:				
Federal funds purchased	\$121,192	\$125,645	\$87,571	
Securities sold under repurchase agreements (short-term portion)	155,941	151,813	150,126	
Federal Home Loan Bank advances (short-term portion)	190,709	76,272	52,504	
Subordinated debentures and term loans (short-term portion)	470	459	79,467	
Total short-term borrowings	\$468,312	\$354,189	\$369,668	
Average Amount Outstanding During the year:				
Federal funds purchased	\$44,674	\$26,789	\$20,072	
Securities sold under repurchase agreements (short-term portion)	130,910	140,126	134,555	
Federal Home Loan Bank advances (short-term portion)	96,284	22,807	20,869	
Subordinated debentures and term loans (short-term portion)	232	187	19,337	
Total short-term borrowings	\$272,100	\$189,909	\$194,833	



Table of Contents

PART I: ITEM 1A. AND ITEM 1B.

ITEM 1A. RISK FACTORS

RISK FACTORS

There are a number of factors, including those specified below, that may adversely affect the Corporation's business, financial results or stock price. Additional risks that the Corporation currently does not know about or currently views as immaterial may also impair the Corporation's business or adversely impact its financial results or stock price.

INDUSTRY AND CORPORATE RISK FACTORS

The Corporation's business and financial results are significantly affected by general business and economic conditions.

The Corporation's business activities and earnings are affected by general business conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, monetary supply, fluctuations in both debt and equity capital markets, and the strength of the United States economy and the state and local economies in which the Corporation operates. For example, a prolonged economic downturn, continued increase in unemployment, or other events that affect household and/or corporate incomes could result in deterioration of credit quality, an increase in the allowance for loan losses, or reduced demand for loan or fee-based products and services. Changes in the financial performance and condition of the Corporation's borrowers could negatively affect repayment of those borrowers' loans. In addition, changes in securities market conditions and monetary fluctuations could adversely affect the availability and terms of funding necessary to meet the Corporation's liquidity needs.

Changes in the domestic interest rate environment could reduce the Corporation's net interest income.

The operations of financial institutions, such as the Corporation, are dependent to a large degree on net interest income, which is the difference between interest income from loans and investments and interest expense on deposits and borrowings. An institution's net interest income is significantly affected by market rates of interest, which in turn are affected by prevailing economic conditions, by the fiscal and monetary policies of the federal government and by the policies of various regulatory agencies. Like all financial institutions, the Corporation's balance sheet is affected by fluctuations in interest rates. Volatility in interest rates can also result in the flow of funds away from financial institutions into direct investments. Direct investments, such as U.S. Government and corporate securities and other investment vehicles, including mutual funds, generally pay higher rates of return than financial institutions, because of the absence of federal insurance premiums and reserve requirements.

Changes in the laws, regulations and policies governing banks and financial services companies could alter the Corporation's business environment and adversely affect operations.

The Board of Governors of the Federal Reserve System regulates the supply of money and credit in the United States. Its fiscal and monetary policies determine in a large part the Corporation's cost of funds for lending and investing and the return that can be earned on those loans and investments, both of which affect the Corporation's net interest margin. Federal Reserve Board policies can also materially affect the value of financial instruments that the Corporation holds, such as debt securities. The Corporation and the Bank are heavily regulated at the federal and state levels. This regulation is to protect depositors, federal deposit insurance funds and the banking system as a whole. Congress and state legislatures and federal and state agencies continually review banking laws, regulations and policies for possible changes. Changes in statutes, regulations or policies could affect the Corporation in substantial and unpredictable ways, including limiting the types of financial services and products that the Corporation offers

and/or increasing the ability of non-banks to offer competing financial services and products.

The Corporation cannot predict whether any of this potential legislation will be enacted, and if enacted, the effect that it or any regulations would have on the Corporation's financial condition or results of operations. See a description of recent legislation in the "Legislature and Regulatory Initiatives to Address Financial and Economic Crises" section of Item 1: Business of this Annual Report on Form 10-K.

The banking and financial services industry is highly competitive, and competitive pressures could intensify and adversely affect the Corporation's financial results.

The Corporation operates in a highly competitive industry that could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. The Corporation competes with other banks, savings and loan associations, mutual savings banks, finance companies, mortgage banking companies, credit unions and investment companies. In addition, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks. Many of the Corporation's competitors have fewer regulatory constraints and some have lower cost structures. Also, the potential need to adapt to industry changes in information technology systems, on which the Corporation and financial services industry are highly dependent, could present operational issues and require capital spending.

Acts or threats of terrorism and political or military actions taken by the United States or other governments could adversely affect general economic or industry conditions.

Geopolitical conditions may also affect the Corporation's earnings. Acts or threats of terrorism and political or military actions taken by the United States or other governments in response to terrorism, or similar activity, could adversely affect general economic or industry conditions.

Table of Contents

PART I: ITEM 1A. AND ITEM 1B.

¶The Corporation's allowance for loan losses may not be adequate to cover actual losses.

The Corporation maintains an allowance for loan losses to provide for loan defaults and non-performance. The allowance for loan losses represents management's estimate of probable losses inherent in the Corporation's loan portfolio. The Corporation's allowance consists of three components: probable losses estimated from individual reviews of specific loans, probable losses estimated from historical loss rates, and probable losses resulting from economic, environmental, qualitative or other deterioration above and beyond what is reflected in the first two components of the allowance. The process for determining the adequacy of the allowance for loan losses is critical to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments, as a result of the need to make estimates about the effect of matters that are uncertain. Therefore, the allowance for loan losses, considering current factors at the time, including economic conditions and ongoing internal and external examination processes, will increase or decrease as deemed necessary to ensure the allowance for loan losses remains adequate. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, loan mix and collateral values.

In connection with recent economic developments, many financial institutions, including the Corporation, have experienced unusual and significant declines in the performance of their loan portfolios, and the values of real estate collateral supporting many loans have declined. If current trends in the housing and real estate markets continue, it is likely that loan delinquencies and credit losses may increase. Although the Corporation believes its underwriting and loan review procedures are appropriate for the various kinds of loans it makes, the Corporation's results of operations and financial condition will be adversely affected in the event the quality of its loan portfolio deteriorates.

¶The Corporation may suffer losses in its loan portfolio despite its underwriting practices.

The Corporation seeks to mitigate the risks inherent in its loan portfolio by adhering to specific underwriting practices. The Corporation's strategy for credit risk management includes conservative credit policies and underwriting criteria for all loans, as well as an overall credit limit for each customer significantly below legal lending limits. The strategy also emphasizes diversification on a regional geographic, industry and customer level, regular credit quality reviews and management reviews of large credit exposures and loans experiencing deterioration of credit quality. There is a continuous review of the loan portfolio, including an internally administered loan "watch" list and an independent loan review. The evaluation takes into consideration identified credit problems, as well as the possibility of losses inherent in the loan portfolio that are not specifically identified. Although the Corporation believes that its underwriting criteria are appropriate for the various kinds of loans it makes, the Corporation may incur losses on loans due to the factors previously discussed.

¶The Corporation faces operational risks because the nature of the financial services business involves a high volume of transactions.

The Corporation operates in diverse markets and relies on the ability of its employees and systems to process a high number of transactions. Operational risk is the risk of loss resulting from the Corporation's operations, including, but not limited to, the risk of fraud by employees or persons outside of the Corporation, the execution of unauthorized transactions by employees, errors relating to transaction processing and technology, breaches of the internal control system and compliance requirements and business continuation and disaster recovery. This risk of loss also includes the potential legal actions that could arise as a result of an operational deficiency or as a result of noncompliance with applicable regulatory standards, adverse business decisions or their implementation, and customer attrition due to potential negative publicity. In the event of a breakdown in the internal control system, improper operation of systems or improper employee actions, the Corporation could suffer financial loss, face regulatory action and suffer damage to



its reputation.

• A natural disaster could harm the Corporation's business.

Natural disasters could harm the Corporation's operations directly through interference with communications, as well as through the destruction of facilities and operational, financial and management information systems. These events could prevent the Corporation from gathering deposits, originating loans and processing and controlling its flow of business.

• The Corporation faces systems failure risks as well as security risks, including "hacking" and "identity theft".

The computer systems and network infrastructure the Corporation uses could be vulnerable to unforeseen problems. The Corporation's operations are dependent upon the ability to protect computer equipment against damage from fire, power loss or telecommunication failure. Any damage or failure that causes an interruption in operations could adversely affect the business and financial results. In addition, computer systems and network infrastructure present security risks, and could be susceptible to hacking or identity theft.

• The Corporation relies on dividends from its subsidiaries for its liquidity needs.

The Corporation is a separate and distinct legal entity from its bank and non-bank subsidiaries. The Corporation receives substantially all of its cash from dividends paid by its subsidiaries. These dividends are the principal source of funds to pay dividends on the Corporation's stock and interest and principal on its debt. Various federal and state laws and regulations limit the amount of dividends that the bank subsidiaries may pay to the Corporation.

Table of Contents

PART I: ITEM 1A. AND ITEM 1B.

• The Corporation's reported financial results depend on management's selection of accounting methods and certain assumptions and estimates.

The Corporation's accounting policies and methods are fundamental to how it records and reports its financial condition and results of operations. The Corporation's management must exercise judgment in selecting and applying many of these accounting policies and methods, so they comply with Generally Accepted Accounting Principles and reflect management's judgment of the most appropriate manner to report the Corporation's financial condition and results. In some cases, management must select the accounting policy or method to apply from two or more alternatives, any of which might be reasonable under the circumstances yet might result in the Corporation's reporting materially different results than would have been reported under a different alternative. Certain accounting policies are critical to presenting the Corporation's financial condition and results, and require management to make difficult, subjective or complex judgments about matters that are uncertain. Materially different amounts could be reported under different conditions or using different assumptions or estimates. These critical accounting policies include: the allowance for loan losses; the valuation of investment securities; the valuation of goodwill and intangible assets; and pension accounting. Because of the uncertainty of estimates involved in these matters, the Corporation may be required to do one or more of the following: significantly increase the allowance for loan losses and/or sustain loan losses that are significantly higher than the reserve provided; recognize significant provision for impairment of its investment securities; recognize significant impairment on its goodwill and intangible assets; or significantly increase its pension liability. As part of its function of assisting the Corporation's Board of Directors in discharging its responsibility of ensuring all types of risk to the organization are properly being managed, mitigated and monitored by management, the Audit Committee of the Board of Directors oversees management's accounting policies and methods. For more information, refer to "CRITICAL ACCOUNTING POLICIES" under Item 7 Part II of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Annual Report on Form 10-K.

- A write-down of all or part of the Corporation's goodwill could materially reduce its net income and net worth.

At December 31, 2014, the Corporation had goodwill of \$202,724,000 recorded on its consolidated balance sheet. Under ASC 340-20, Other Assets and Deferred Costs, the Corporation is required to evaluate goodwill for impairment on an annual basis, as well as on an interim basis, if events or changes indicate that the asset may be impaired. An impairment loss must be recognized for any excess of carrying value over the fair value of goodwill. The fair value is determined based on internal valuations using management's assumptions of future growth rates, future attrition, discount rates, multiples of earnings or other relevant factors. The resulting estimated fair value could result in material write-downs of goodwill and recording of impairment losses. Such a write-down could materially reduce the Corporation's net income and overall net worth. The Corporation also cannot predict the occurrence of certain future events that might adversely affect the fair value of goodwill. Such events include, but are not limited to, strategic decisions made in response to economic and competitive conditions, the effect of the economic environment on the Corporation's customer base, or a material negative change in its relationship with significant customers.

• Changes in accounting standards could materially impact the Corporation's financial statements.

From time to time, the Financial Accounting Standards Board changes the financial accounting and reporting standards that govern the preparation of the Corporation's financial statements. These changes can be hard to predict and can materially impact how the Corporation records and reports its financial condition and results of operations. In some cases, the Corporation could be required to apply a new or revised standard retroactively; resulting in the restating of prior period financial statements.

Significant legal actions could subject the Corporation to substantial uninsured liabilities.

The Corporation is from time to time subject to claims related to its operations. These claims and legal actions, including supervisory actions by the Corporation's regulators, could involve large monetary claims and significant defense costs. To protect itself from the cost of these claims, the Corporation maintains insurance coverage in amounts and with deductibles that it believes are appropriate for its operations. However, the Corporation's insurance coverage may not cover all claims against the Corporation or continue to be available to the Corporation at a reasonable cost. As a result, the Corporation may be exposed to substantial uninsured liabilities, which could adversely affect the Corporation's results of operations and financial condition

Negative publicity could damage the Corporation's reputation and adversely impact its business and financial results.

Reputation risk, or the risk to the Corporation's earnings and capital from negative publicity, is inherent in the Corporation's business. Negative publicity can result from the Corporation's actual or alleged conduct in any number of activities, including lending practices, corporate governance and acquisitions, and actions taken by government regulators and community organizations in response to those activities. Negative publicity can adversely affect the Corporation's ability to keep and attract customers and can expose the Corporation to litigation and regulatory action. Although the Corporation takes steps to minimize reputation risk in dealing with customers and other constituencies, the Corporation is inherently exposed to this risk.

Acquisitions may not produce revenue enhancements or cost savings at levels or within timeframes originally anticipated and may result in unforeseen integration difficulties.

The Corporation regularly explores opportunities to acquire banks, financial institutions, or other financial services businesses or assets. The Corporation cannot predict the number, size or timing of acquisitions. Difficulty in integrating an acquired business or company may cause the Corporation not to realize expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits from the acquisition. The integration could result in higher than expected deposit attrition (run-off), loss of key employees, disruption of the Corporation's business or the business of the acquired company, or otherwise adversely affect the Corporation's ability to maintain relationships with customers and employees or achieve the anticipated benefits of the acquisition. Also, the negative effect of any divestitures required by regulatory authorities in acquisitions or business combinations may be greater than expected.

Table of Contents

PART I: ITEM 1A. AND ITEM 1B.

¶The Corporation may not be able to pay dividends in the future in accordance with past practice.

The Corporation has traditionally paid a quarterly dividend to common stockholders. The payment of dividends is subject to legal and regulatory restrictions. Any payment of dividends in the future will depend, in large part, on the Corporation's earnings, capital requirements, financial condition and other factors considered relevant by the Corporation's Board of Directors.

¶The Corporation's stock price can be volatile.

The Corporation's stock price can fluctuate widely in response to a variety of factors, including: actual or anticipated variations in the Corporation's quarterly operating results; recommendations by securities analysts; significant acquisitions or business combinations; strategic partnerships, joint ventures or capital commitments; operating and stock price performance of other companies that investors deem comparable to the Corporation; new technology used or services offered by the Corporation's competitors; news reports relating to trends, concerns and other issues in the banking and financial services industry, and changes in government regulations. General market fluctuations, industry factors and general economic and political conditions and events, including terrorist attacks, economic slowdowns or recessions, interest rate changes, credit loss trends or currency fluctuations, could also cause the Corporation's stock price to decrease, regardless of the Corporation's operating results.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

Table of Contents

PART I: ITEM 2., ITEM 3. AND ITEM 4.

ITEM 2. PROPERTIES.

The headquarters of the Corporation and the Bank is located at 200 East Jackson Street, Muncie, Indiana. The building is owned by the Bank.

The Bank conducts business through numerous facilities owned and leased. Of the 106 banking offices operated by the Bank, 78 are owned and 28 are leased from non-affiliated third parties.

None of the properties owned by the Corporation are subject to any major encumbrances. The net investment of the Corporation and subsidiaries in real estate and equipment at December 31, 2014 was \$77,691,000.

ITEM 3. LEGAL PROCEEDINGS.

There is no pending legal proceeding, other than ordinary routine litigation incidental to the business of the Corporation or its subsidiaries, of a material nature to which the Corporation or its subsidiaries is a party or of which any of their properties are subject. Further, there is no material legal proceeding in which any director, officer, principal shareholder, or affiliate of the Corporation, or any associate of any such director, officer or principal shareholder, is a party, or has a material interest, adverse to the Corporation or any of its subsidiaries.

None of the routine legal proceedings, individually or in the aggregate, in which the Corporation or its affiliates are involved are expected to have a material adverse impact on the financial position or the results of operations of the Corporation.

ITEM 4. MINE SAFETY DISCLOSURES.

Not applicable.

Table of Contents

SUPPLEMENTAL INFORMATION

SUPPLEMENTAL INFORMATION - EXECUTIVE OFFICERS OF THE REGISTRANT

The names, ages, and positions with the Corporation and the Bank of all executive officers of the Corporation and all persons chosen to become executive officers are listed below. The officers are elected by the Board of Directors of the Corporation for a term of one year or until the election of their successors. There are no arrangements between any officer and any other person pursuant to which he or she was selected as an officer.

Michael C. Rechin, 56, President and Chief Executive Officer, Corporation  
Chief Executive Officer of the Corporation since April 2007; Chief Operating Officer of the Corporation from November 2005 to April 2007; Executive Vice President, Corporate Banking National City Bank from 1995 to November 2005.

Mark K. Hardwick, 44, Executive Vice President and Chief Financial Officer, Corporation  
Executive Vice President and Chief Financial Officer of the Corporation since December 2005; Senior Vice President and Chief Financial Officer of the Corporation from April 2002 to December 2005; Corporate Controller of the Corporation from November 1997 to April 2002.

Michael J. Stewart, 49, Executive Vice President and Chief Banking Officer, Corporation  
Executive Vice President and Chief Banking Officer of the Corporation since February 2008; Executive Vice President from December 2006 to February 2008 of National City Corp; Executive Vice President and Chief Credit Officer of National City Bank of Indiana from December 2002 to December 2006.

John J. Martin, 48, Executive Vice President and Chief Credit Officer, Corporation  
Executive Vice President and Chief Credit Officer of the Corporation since March 2013; Senior Vice President and Chief Credit Officer of the Corporation from June 2009 to March 2013; First Vice President and Deputy Chief Credit Officer of the Corporation from July 2008 to June 2009; First Vice President and Senior Manager of Lending Process of the Corporation from January 2008 to July 2008; Senior Vice President and Regional Senior Credit Officer of National City Bank from May 2000 to December 2007.

Stephan H. Fluhler, 46, Senior Vice President, Chief Information Officer, Corporation  
Senior Vice President and Chief Information Officer of the Corporation since May 2014; Chief Technology Officer of the Corporation from 2004 to May 2014; Director of Technology Services and Change Management of the Corporation from December 2003 to 2004.

Kimberly J. Ellington, 55, Senior Vice President and Director of Human Resources, Corporation  
Senior Vice President and Director of Human Resources of the Corporation since 2004; Vice President and Director of Human Resources of the Corporation from 1999 to 2004.

Jeffrey B. Lorentson, 51, Senior Vice President and Chief Risk Officer, Corporation  
Senior Vice President and Chief Risk Officer of the Corporation since June 2007; Corporate Controller of First Indiana Bank from June 2006 to June 2007; First Vice President and Corporate Controller of the Corporation from 2003 to 2006; Vice President and Corporate Controller of the Corporation from 2002 to 2003.

Table of Contents

PART II: ITEM 5. AND ITEM 6.

## PART II

## ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

## PERFORMANCE GRAPH

The following graph compares the cumulative 5-year total return to shareholders on First Merchants Corporation's common stock relative to the cumulative total returns of the Russell 2000 index, the SNL Bank \$1B - \$5B index, and the SNL Bank \$5B - \$10B index. The graph assumes that the value of the investment in the Corporation's common stock and in each of the indexes (including reinvestment of dividends) was \$100 on December 31, 2009 and tracks it through December 31, 2014.

Index	Period Ending					
	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014
First Merchants Corporation	\$ 100.00	\$ 149.93	\$ 144.04	\$ 254.35	\$ 393.46	\$ 399.45
Russell 2000	100.00	126.86	121.56	141.43	196.34	205.95
SNL Bank \$1B-\$5B	100.00	113.35	103.38	127.47	185.36	193.81
SNL Bank \$5B-\$10B	100.00	108.48	107.66	126.64	195.38	201.25

The stock price performance included in this graph is not necessarily indicative of future stock price performance.

Table of Contents

## PART II: ITEM 5. AND ITEM 6.

## STOCK INFORMATION

Quarter	Price Per Share				Dividends Declared <sup>(1)</sup>	
	HIGH		LOW		2014	2013
	2014	2013	2014	2013	2014	2013
First quarter	\$22.66	\$15.97	\$19.74	\$14.51	\$0.05	\$0.03
Second quarter	22.80	17.48	19.38	14.08	0.08	0.05
Third quarter	22.10	19.15	19.46	16.67	0.08	0.05
Fourth quarter	23.39	23.35	19.94	17.34	0.08	0.05

Numbers rounded to nearest cent when applicable.

The table above lists per share prices and dividend payments during 2014 and 2013. Prices are as reported by the National Association of Securities Dealers Automated Quotation – Global Select Market System.

## COMMON STOCK LISTING

First Merchants Corporation common stock is traded over-the-counter on the NASDAQ Global Select Market System. Quotations are carried in many daily papers. The NASDAQ symbol is FRME (Cusip #320817-10-9). At the close of business on February 20, 2015, the number of shares outstanding was 37,680,604. There were 5,676 stockholders of record on that date.

## PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASES

There were no purchases of the Corporation's common stock by or on behalf of the Corporation during the quarter ended December 31, 2014.



---

(1) The “DIVIDEND LIMITATIONS” section of “BUSINESS” included as Item 1 of this Annual Report on Form 10-K, the “CAPITAL” and “LIQUIDITY” sections of “Management's Discussion & Analysis of Financial Condition and Results of Operations” included as Item 7 of this Annual Report on Form 10-K and Note 16. STOCKHOLDERS' EQUITY to the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K include discussions regarding dividend restrictions.

28

---

Table of Contents

## PART II: ITEM 5. AND ITEM 6.

## EQUITY COMPENSATION PLAN INFORMATION

The following table provides information about the Corporation's common stock that may be issued under equity compensation plans as of December 31, 2014.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercised price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensations plans (excluding securities reflected in first column)
Equity compensation plans approved by stockholders	737,931	\$ 20.99	752,634
Total	737,931	\$ 20.99	752,634

Table of Contents

## PART II: ITEM 5. AND ITEM 6.

## ITEM 6. SELECTED FINANCIAL DATA.

(Dollars in Thousands, Except Share Data)	2014	2013	2012	2011	2010
Operations <sup>(1) (2) (3)</sup>					
Net interest income fully taxable equivalent (FTE) basis	\$ 194,958	\$ 160,308	\$ 158,081	\$ 149,114	\$ 149,434
Less tax equivalent adjustment	7,921	6,043	5,745	5,759	5,865
Net interest income	187,037	154,265	152,336	143,355	143,569
Provision for loan losses	2,560	6,648	18,534	22,630	46,483
Net interest income after provision for loan losses	184,477	147,617	133,802	120,725	97,086
Total other income	65,667	54,809	64,302	49,120	48,544
Total other expenses	168,592	143,219	137,115	135,938	142,311
Income before income tax expense (benefit)	81,552	59,207	60,989	33,907	3,319
Income tax expense (benefit)	21,390	14,677	15,867	8,655	(3,590 )
Net income	60,162	44,530	45,122	25,252	6,909
Gain on exchange of preferred stock to trust preferred debt					11,353
Loss on CPP unamortized discount				(1,401 )	(1,301 )
Loss on extinguishment of trust preferred securities				(10,857 )	
Preferred stock dividends and discount accretion		(2,380 )	(4,539 )	(3,981 )	(5,239 )
Net income available to common stockholders	\$ 60,162	\$ 42,150	\$ 40,583	\$ 9,013	\$ 11,722
Per Share Data					
Basic net income available to common stockholders	\$ 1.66	\$ 1.42	\$ 1.42	\$ 0.34	\$ 0.48
Diluted net income available to common stockholders	1.65	1.41	1.41	0.34	0.48
Cash dividends paid - common	0.29	0.18	0.10	0.04	0.04
December 31 book value - common	19.29	17.67	16.08	14.83	15.11
December 31 tangible book value - common	13.65	12.17	10.95	9.64	9.21
December 31 market value (bid price) - common	22.75	22.72	14.84	8.47	8.86
Average Balances <sup>(1) (2) (3)</sup>					
Total assets	\$ 5,571,354	\$ 4,455,411	\$ 4,245,996	\$ 4,143,850	\$ 4,271,715
Total Loans <sup>(4)</sup>	3,730,080	3,008,555	2,819,816	2,748,684	3,050,850
Earning assets	4,985,338	4,017,247	3,833,174	3,744,027	3,862,493
Total deposits	4,363,955	3,465,640	3,263,020	3,175,762	3,337,747
Total stockholders' equity	675,295	540,255	535,497	478,440	470,379
Year-End Balances <sup>(1) (2) (3)</sup>					
Total assets	\$ 5,824,127	\$ 5,437,262	\$ 4,304,821	\$ 4,173,076	\$ 4,170,848

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Total Loans <sup>(4)</sup>	3,932,100	3,637,740	2,924,509	2,731,279	2,857,152
Allowance for loan losses	63,964	67,870	69,366	70,898	82,977
Total deposits	4,640,694	4,231,468	3,346,383	3,134,655	3,268,880
Total stockholders' equity	726,827	634,923	552,236	514,467	454,408

Financial Ratios <sup>(1) (2) (3)</sup>

Return on average assets	1.08	% 0.95	% 0.96	% 0.22	% 0.27	%
Return on average stockholders' equity	8.91	7.80	7.58	1.88	2.49	
Average earning assets to total assets	89.48	90.17	90.28	90.35	90.42	
Allowance for loan losses as % of total loans	1.63	1.87	2.37	2.60	2.90	
Dividend payout ratio	17.58	12.77	7.09	11.76	8.33	
Average stockholders' equity to average assets	12.12	12.13	12.61	11.55	11.01	
Tax equivalent yield on earning assets	4.35	4.40	4.74	4.99	5.32	
Cost of supporting liabilities	0.44	0.41	0.62	1.01	1.45	
Net interest margin on earning assets	3.91	3.99	4.12	3.98	3.87	

<sup>(1)</sup> Effective February 10, 2012, the Bank assumed substantially all of the deposits and certain other liabilities and acquired certain assets of SCB Bank, a federal savings bank headquartered in Shelbyville, Indiana, from the Federal Deposit Insurance Corporation ("FDIC"), as receiver for SCB Bank, pursuant to the terms of the Purchase and Assumption Agreement - Modified Whole Bank; All Deposits (the "Agreement"), entered into by the Bank, the FDIC as receiver of SCB Bank and the FDIC. Under the terms of the Agreement, the Bank acquired \$147.7 million in assets, including approximately \$11.9 million of cash and cash equivalents, \$18.9 million of marketable securities, \$1.8 million in Federal Home Loan Bank stock, \$113.0 million in loans and \$2.1 million of premises and other assets. The asset balances are book balances and do not reflect the fair value discount of \$29.0 million from book value. The Bank assumed approximately \$135.7 million of liabilities, including \$125.9 million in customer deposits, \$9.6 million of other borrowings and \$402,000 in other liabilities. The bid accepted by the FDIC included no deposit premium.

<sup>(2)</sup> Effective November 12, 2013, the Corporation acquired 100 percent of CFS Bancorp, Inc. ("CFS") in an all stock transaction. CFS was headquartered in Munster, Indiana and had 20 banking centers in northwestern Indiana and northeastern Illinois. Pursuant to the merger agreement, the shareholders of CFS received 0.65 percent of a share of the Corporation's common stock for each share of CFS common stock held. The Corporation issued approximately 7.1 million shares of common stock, which was valued at approximately \$135.6 million. The details of the acquisition can be found in Note 3. BUSINESS COMBINATIONS, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

<sup>(3)</sup> Effective November 7, 2014, the Corporation acquired 100 percent of Community Bancshares, Inc. ("Community"). Community was headquartered in Noblesville, IN and had 10 banking centers serving central Indiana. Pursuant to the merger agreement, each outstanding share of common stock of Community was converted into the right to receive either (a) 4.0926 shares of First Merchants' common stock, plus cash in lieu of fractional shares; or (b) \$85.94 in cash, based upon shareholder elections. The Corporation paid \$14.2 million in cash and issued approximately 1.6 million shares of common stock, valued at \$35.0 million, for a total purchase price of approximately \$49.2 million. The details of the acquisition can be found in Note 3. BUSINESS COMBINATIONS, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

<sup>(4)</sup> Includes loans held for sale.

Table of Contents

PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

CRITICAL ACCOUNTING POLICIES

Generally accepted accounting principles require management to apply significant judgment to certain accounting, reporting and disclosure matters. Management must use assumptions and estimates to apply those principles where actual measurement is not possible or practical. For a complete discussion of the Corporation's significant accounting policies, see Note 1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K for additional detail.

RESULTS OF OPERATIONS – 2014

Net income available to stockholders was \$60.2 million, or \$1.65 per fully diluted common share, an increase of \$18.0 million compared to \$42.2 million, or \$1.41 per fully diluted common share in 2013. On November 12, 2013, the Corporation acquired CFS Bancorp, Inc. ("CFS"), and on November 7, 2014, the Corporation acquired Community Bancshares, Inc. ("Community"). Details of both transactions are included in Note 3. BUSINESS COMBINATIONS, included within the Notes to Consolidated Condensed Financial Statements included as Item 8 of this Annual Report on Form 10-K.

As of December 31, 2014, total assets equaled \$5.8 billion, an increase of \$386.9 million from December 31, 2013. Loans and investments, the Corporation's primary earning assets, totaled \$5.1 billion, an increase of \$379.4 million from the prior year's total of \$4.7 billion. Investments increased \$85.1 million and total loans increased \$294.3 million. The Corporation acquired \$145.1 million in loans as a result of the Community acquisition.

The Corporation's allowance for loan losses totaled \$64.0 million as of December 31, 2014. The allowance provides 131.1 percent coverage of all non-accrual loans and 1.63 percent of total loans. Details of the Allowance for Loan Losses and non-performing loans are discussed within the "Loan Quality" and "Provision and Allowance for Loan Losses" sections of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

The Corporation recognized increases in goodwill and core deposit intangible of \$13.8 million and \$4.7 million, respectively, as a result of the Community acquisition.

At December 31, 2014, other real estate owned totaled \$19.3 million, a decrease of \$2.9 million from the December 31, 2013 balance of \$22.2 million. Included in the December 31, 2014 balance was \$6.7 million acquired in the Community acquisition.

Taxes, both current and deferred, decreased in 2014 by \$14.7 million. Details related to the change in taxes are discussed within the "Income Taxes" section of the Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K and in Note 22. INCOME TAX of the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

Other assets of \$20.8 million at December 31, 2014, decreased \$8.2 million from December 31, 2013. Included in the decrease was an \$11.1 million decrease in prepaid pension expense. Additional details related to the prepaid pension

expense are discussed in Note 21. PENSION AND OTHER POST RETIREMENT BENEFIT PLANS, of the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

Deposits increased \$409.2 million from December 31, 2013, while borrowings decreased \$111.3 million during the same period. As part of the Community acquisition, the Bank acquired deposits of \$228.4 million.

As part of the Community acquisition, the Corporation issued approximately 1.6 million shares of common stock valued at \$35.0 million. Additional details of this transaction are discussed in Note 16. STOCKHOLDERS' EQUITY of the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

The Corporation was able to maintain all regulatory capital ratios in excess of the regulatory definition of “well-capitalized” as discussed in the “CAPITAL” section of Management’s Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

Table of Contents

PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS – 2013

Net income available to stockholders was \$42.2 million, or \$1.41 per fully diluted common share, an increase of \$1.6 million compared to \$40.6 million, or \$1.41 per fully diluted common share in 2012. Included in the 2013 results were \$5.4 million, or \$.12 per fully diluted common share, of non-recurring acquisition related expenses. On November 12, 2013, the Corporation acquired 100 percent of CFS Bancorp, Inc. ("CFS") in an all stock transaction as discussed in Note 3. BUSINESS COMBINATIONS, included within the Notes to Consolidated Condensed Financial Statements included as Item 8 of this Annual Report on Form 10-K. By contrast, 2012 results included a \$9.1 million, or \$0.21 per fully diluted common share after tax gain from the February 10, 2012, acquisition of certain assets and assumption of substantially all the deposits and certain other liabilities of SCB Bank, from the FDIC as the receiver for SCB Bank. Details of this transaction are included in Note 2. PURCHASE AND ASSUMPTION, included within the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

As of December 31, 2013, total assets equaled \$5.4 billion, an increase of \$1.1 billion from December 31, 2012. Loans and investments, the Corporation's primary earning assets, totaled \$4.7 billion, up \$934.4 million from the prior year's total of \$3.8 billion. Investments increased by \$221.2 million primarily due to liquidity provided by the CFS acquisition. Loans and loans held for sale increased \$713.2 million. The Corporation acquired \$603.3 million in loans and loans held for sale as a result of the CFS acquisition. Additional details of these changes are included within the "Earning Assets" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

The Corporation's allowance for loan losses totaled \$67.9 million as of year end 2013. The allowance provides 120.3 percent coverage of all non-accrual loans and 1.87 percent of total loans. Details of the Allowance for Loan Losses and non-performing loans are discussed within the "Loan Quality" and "Provision and Allowance for Loan Losses" sections of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

Taxes, both current and deferred, increased in 2013 by \$25.7 million. This change was primarily driven by a \$30.7 million increase resulting from the CFS acquisition. Additional details related to the change are discussed within the "Income Tax" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

The Corporation recognized increases in premises and equipment and cash surrender value of life insurance of \$19.6 million and \$36.6 million, respectively, as a result of the CFS acquisition. In addition, the excess of net tangible assets acquired was allocated to a core deposit intangible of \$7.3 million and goodwill of \$47.6 million. Additional details relating to the net tangible assets acquired are discussed in Note 3. BUSINESS COMBINATIONS, included within the Notes to Consolidated Condensed Financial Statements included as Item 8 of this Annual Report on Form 10-K.

Deposits increased \$885.1 million from December 31, 2012. As part of the CFS acquisition, the Bank acquired deposits of \$955.7 million. Additional details related to the change are discussed within the "Deposits and Borrowings" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

On November 1, 2013, the Corporation completed the private issuance and sale to four institutional investors of an aggregate of \$70 million of debt comprised of (a) 5.00 percent Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million (the "Senior Debt") and (b) 6.75 percent Fixed-to-Floating Rate Subordinated

Notes due 2028 in the aggregate principal amount of \$65 million (the "Subordinated Debt"). The net proceeds of the placement were used to pay off the Corporation's \$55 million credit facility with Bank of America, N.A. which was scheduled to mature on February 15, 2015. Details of this transaction are included in Note 12. BORROWINGS, included within the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

In three separate transactions during 2013, the Corporation redeemed all 90,782.94 outstanding shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock") held by the U.S. Department of the Treasury (the "Treasury"). The Series B Preferred Stock had been issued to the Treasury in September of 2011 as part of the Corporation's participation in the Small Business Lending Fund Program ("SBLF"). Additional details related to the Corporation's SBLF related Preferred Stock redemptions are discussed in Note 16. STOCKHOLDERS' EQUITY, included within the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

The Corporation was able to maintain all regulatory capital ratios in excess of the regulatory definition of "well-capitalized" as discussed in the "Capital" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.



Table of Contents

## PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## Net Interest Income

Net interest income is the primary source of the Corporation's earnings. Net interest margin is a function of net interest income and the level of average earning assets. The following table presents the Corporation's interest income, interest expense, and net interest income as a percent of average earning assets for the three-year period ending in 2014.

	Average Balance	Interest Income / Expense	Average Rate	Average Balance	Interest Income / Expense	Average Rate	Average Balance	Interest Income / Expense	Average Rate
(Dollars in Thousands)	2014			2013			2012		
Assets:									
Interest-bearing deposits	\$53,231	\$124	0.2 %	\$74,964	\$158	0.2 %	57,842	100	0.2 %
Federal reserve and federal home loan bank stock	42,142	2,124	5.0	33,620	1,488	4.4	32,819	1,408	4.3
Securities: <sup>(1)</sup>									
Taxable	763,450	19,882	2.6	617,524	15,214	2.5	670,973	17,027	2.5
Tax-Exempt <sup>(2)</sup>	396,435	22,127	5.6	282,584	16,660	5.9	251,724	15,675	6.2
Total securities	1,159,885	42,009	3.6	900,108	31,874	3.5	922,697	32,702	3.5
Loans held for sale	6,681	485	7.3	16,137	770	4.8	20,648	1,024	5.0
Loans: <sup>(3)</sup>									
Commercial	2,919,020	133,567	4.6	2,391,221	113,613	4.8	2,166,238	114,078	5.3
Real estate mortgage	429,384	19,812	4.6	277,520	12,375	4.5	293,384	13,848	4.7
Installment	361,484	18,175	5.0	308,233	15,994	5.2	324,553	17,795	5.5
Tax-Exempt <sup>(2)</sup>	13,511	504	3.7	15,444	605	3.9	14,993	739	4.9
Total loans	3,730,080	172,543	4.6	3,008,555	143,357	4.8	2,819,816	147,484	5.2
Total earning assets	4,985,338	216,800	4.3 %	4,017,247	176,877	4.4 %	3,833,174	181,694	4.7 %
Net unrealized gain on securities available for sale	8,921			4,521			16,116		
Allowance for loan losses	(67,969 )			(68,806 )			(71,038 )		
Cash and due from banks	87,068			73,161			66,109		
Premises and equipment	75,202			57,228			51,692		
Other assets	482,794			372,060			349,943		
Total assets	\$5,571,354			\$4,455,411			\$4,245,996		
Liabilities:									
Interest-bearing deposits:									
NOW accounts	\$1,066,402	\$1,110	0.1 %	\$880,323	\$941	0.1 %	\$814,831	\$1,007	0.1 %
Money market deposit accounts	776,712	1,572	0.2	603,012	1,287	0.2	501,537	1,370	0.3

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Savings deposits	533,080	619	0.1	377,106	421	0.1	327,644	528	0.2
Certificates and other time deposits	1,042,539	8,377	0.8	807,764	7,404	0.9	935,713	11,895	1.3
Total interest-bearing deposits	3,418,733	11,678	0.3	2,668,205	10,053	0.4	2,579,725	14,800	0.6
Borrowings	492,128	10,164	2.1	400,580	6,516	1.6	411,915	8,813	2.1
Total interest-bearing liabilities	3,910,861	21,842	0.6	3,068,785	16,569	0.5	2,991,640	23,613	0.8
Noninterest-bearing deposits	945,222			797,435			683,295		
Other liabilities	39,976			48,936			35,564		
Total liabilities	4,896,059			3,915,156			3,710,499		
Stockholders' Equity	675,295			540,255			535,497		
Total Liabilities and Stockholders' Equity	\$5,571,354	21,842	0.4	\$4,455,411	16,569	0.4	\$4,245,996	23,613	0.6
Net Interest Income		\$194,958			\$160,308			\$158,081	
Net Interest Margin			3.9 %			4.0 %			4.1 %

(1) Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustment.

(2) Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 35 percent for 2014, 2013 and 2012. These totals equal \$7,921, \$6,043 and \$5,745, respectively.

(3) Non-accruing loans have been included in the average balances.

Table of Contents

PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In 2014, asset yields decreased 5 basis points on a fully taxable equivalent basis (FTE) and interest cost increased 3 basis points, resulting in an 8 basis points decrease in net interest margin compared to 2013. In 2013, average earning assets only included approximately six weeks of averages related to assets acquired from CFS; however, 2014 included an entire year of averages. Average earning assets increased \$968,091,000 and were a result of larger loan and investment portfolios, which has positive volume variances of \$33,894,000 and \$9,393,000, respectively. In addition, a low interest rate environment produced a negative rate variance of \$5,934,000 (FTE), resulting in a net increase of \$32,772,000 (FTE) in net interest income.

In 2013, asset yields decreased 34 basis points on fully taxable equivalent basis (FTE) and interest cost decreased 21 basis points, resulting in a 13 basis point decrease in net interest margin compared to 2012. An increase in earnings assets, primarily due to a larger loan portfolio as a result of the CFS transaction, resulted in a positive volume variance of \$10,087,000. In addition, a low interest rate environment produced a negative rate variance of \$8,158,000 (FTE), resulting in a net increase of \$1,929,000 in net interest income.

Average earning assets include the average balance of securities classified as available for sale, computed based on the average of the historical amortized cost balances without the effects of the fair value adjustment. In addition, annualized amounts are computed utilizing a 30/360 day basis.

Non-Interest Income

Non-Interest income increased \$10.9 million, or 19.8 percent, in 2014 compared to 2013. The November 12, 2013 acquisition of CFS was the largest contributing factor to the year-over-year increase.

Significant increases realized during 2014 when compared to 2013 included service charge income, other customer fees (primarily electronic card interchange fees and investment brokerage fees) and other income, including gains on sale of other real estate owned, totaling \$3.3 million, \$3.8 million and \$1.5 million, respectively. Additionally, gains on the sale of investment securities increased \$3.1 million from 2013 to 2014. Additional details on investment securities can be found in Note 5. INVESTMENT SECURITIES, included within the Notes to Consolidated Condensed Financial Statements of this form 10-K. Finally, 2014 earnings on cash surrender value of life insurance increased \$1.0 million from the previous year, primarily due to receipt of an \$846,000 death benefit from Bank Owned Life Insurance during the period.

Partially offsetting the year-over-year increases was a \$2.6 million decrease in net gains recognized on the sale of mortgage loans. Mortgage origination and refinance volumes decreased from 2013 levels as a result of interest rate and economic factors.

The November 7, 2014 Community acquisition resulted in \$201,000 of non-interest income during the last seven weeks of 2014.

In 2013, non-interest income decreased \$9.5 million, or 14.8 percent in comparison to 2012. The largest item contributing to the decrease was a gross purchase gain of \$9.1 million recognized in 2012 from the purchase of certain assets and assumption of certain liabilities of SCB Bank. Details of this transaction are included within Note 2. PURCHASE AND ASSUMPTION of the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

Additionally, earnings on cash surrender value of life insurance decreased by \$805,000 compared to 2012. This decrease was primarily driven by a death benefit of \$576,000 received from Bank Owned Life Insurance during 2012. Finally, gains on the sale of mortgage loans, gains on the sale of investment securities and tax credit fund income declined by \$3.1 million, \$1.9 million and \$1.0 million, respectively, in 2013 when compared to 2012.

Offsetting these declines were significant increases in gains on sale of OREO, insurance commissions, customer service charges, fiduciary activities, and investment service commissions of \$3.0 million, \$917,000, \$813,000, \$703,000 and \$463,000, respectively, in 2013 when compared to 2012.

The November 12, 2013 CFS acquisition resulted in \$1.2 million of non-interest income during the last seven weeks of 2013. Of this \$1.2 million, the largest components were \$581,000 of customer service charges and \$325,000 of electronic interchange fees.

#### Non-Interest Expenses

Non-interest expenses increased \$25.4 million, or 17.7 percent, in 2014 compared to 2013. As with non-interest income, the CFS acquisition was the most significant factor in the year-over-year increase.

In 2014, salaries and employee benefits increased \$11.1 million, or 13.0 percent, over 2013 due to the addition of CFS employees since the acquisition. The Corporation also experienced a \$3.5 million increase in net occupancy expense, as 20 banking center locations were added to the Bank's footprint as a result of the CFS acquisition. In addition to the non-interest expense increases associated with operating a larger organization, 2014 included \$1.5 million of non-recurring expenses associated with the CFS acquisition.

Additionally, the Community acquisition resulted in \$2.2 million of one-time expenses in 2014. Furthermore, Community added \$646,000 of non-interest expense in the last seven weeks of 2014.

Table of Contents

PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In 2013, non-interest expenses increased \$6.1 million, or 4.5 percent, compared to 2012. Salaries and employee benefits increased by \$6.0 million, with the largest factor being \$2.5 million of non-recurring severance expenses related to the CFS acquisition. In addition, salaries and employee benefits increased by \$2.1 million due to the addition of CFS employees since acquisition. Additionally, professional and other outside services were \$2.1 million higher in 2013 than 2012 due primarily to expenses associated with the acquisition and integration of CFS.

The increases in salary and employee benefits and other expenses were offset by year over year declines in other real estate owned and credit-related expenses of \$1.5 million and FDIC assessment expense of \$647,000.

Overall, the CFS acquisition, resulted in \$8.9 million of non-interest expense during 2013.

Income Tax Expense

Income tax expense in 2014 was \$21,390,000 on pre-tax income of \$81,552,000, or 26.2 percent. For the same period in 2013, income tax expense was \$14,677,000 on pre-tax income of \$59,207,000, or 24.8 percent. Additional details are discussed within the "INCOME TAXES" section of the Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K and in Note 22. INCOME TAX of the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

CAPITAL

To be categorized as well capitalized, the Bank must maintain a minimum total capital to risk-weighted assets, Tier I capital to risk-weighted assets and Tier I capital to average assets of 10 percent, 6 percent and 5 percent, respectively. The Corporation's regulatory capital exceeded the regulatory "well capitalized" standard at December 31, 2014. See additional information on the Corporation's and Bank's capital ratios in Note 18. REGULATORY CAPITAL, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

Tier I regulatory capital consists primarily of total stockholders' equity and subordinated debentures issued to business trusts categorized as qualifying borrowings, less non-qualifying intangible assets and unrealized net securities gains or losses. The Corporation's Tier I capital to average assets ratio was 10.15 percent and 10.20 percent at December 31, 2014 and 2013, respectively.

At December 31, 2014, the Corporation had a Tier I risk-based capital ratio of 12.63 percent and total risk-based capital ratio of 15.34 percent, compared to 11.71 percent and 14.54 percent, respectively, at December 31, 2013. Regulatory capital guidelines require a Tier I risk-based capital ratio of at least 4 percent and a total risk-based capital ratio of at least 8 percent.

On September 22, 2011, the Corporation entered into a Securities Purchase Agreement with the Treasury, pursuant to which the Corporation issued 90,782.94 shares of the Corporation's Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock"), having a liquidation amount per share equal to \$1,000, for a total purchase price of \$90,782,940. The Purchase Agreement was entered into, and the Series B Preferred Stock was issued, pursuant to the SBLF program, a \$30 billion fund established under the Small Business Jobs Act of 2010, that encourages lending to small businesses by providing capital to qualified community banks with assets of less than \$10 billion.

On January 3, 2013, the Corporation redeemed 22,695.94 shares of the Series B Preferred Stock held by the Treasury at an aggregate redemption price of \$22,695,940 plus accrued but unpaid dividends. Following the redemption, the Treasury held 68,087 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately \$68 million.

On July 2, 2013, the Corporation redeemed an additional 34,044 shares of the Series B Preferred Stock held by the Treasury at an aggregate redemption price of \$34,044,000 plus accrued but unpaid dividends. Following the redemption, the Treasury held 34,043 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately \$34 million.

On November 12, 2013, the Corporation acquired 100 percent of CFS in an all stock transaction. Pursuant to the merger agreement, the shareholders of CFS received 0.65 percent of a share of the Corporation's common stock for each share of CFS Bancorp common stock held. The Corporation issued approximately 7.1 million shares of common stock, which was valued at approximately \$135.7 million. This transaction resulted in a core deposit intangible of \$7,313,000 and goodwill of \$47,573,000.

On November 22, 2013, the Corporation redeemed the final 34,043 shares of the Series B Preferred Stock held by the Treasury at an aggregate redemption price of \$34,043,000 plus accrued but unpaid dividends. There are no shares of the Corporation's Series B Preferred Stock currently outstanding.

On November 7, 2014, the Corporation acquired 100 percent of Community. Pursuant to the merger agreement, each outstanding share of common stock of Community was converted into the right to receive either (a) 4.0926 shares of First Merchants' common stock, plus cash in lieu of fractional shares; or (b) \$85.94 in cash, based upon shareholder elections. The Corporation paid \$14.2 million in cash and issued approximately 1.6 million shares of common stock, valued at approximately \$35.0 million, for a total purchase price of approximately \$49.2 million.

Table of Contents

## PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management believes that all of the above capital ratios are meaningful measurements for evaluating the safety and soundness of the Corporation. Additionally, management believes the following table is meaningful when considering performance measures of the Corporation. The table below details and reconciles tangible earnings per share, return on tangible capital and tangible assets to traditional GAAP measures.

(Dollars in Thousands, Except Per Share Amounts)	December 31, 2014	December 31, 2013		
Average goodwill	\$ 191,033	\$ 147,785		
Average core deposit intangible (CDI)	13,323	8,367		
Average deferred tax on CDI	(5,002 )	(2,633 )		
Intangible adjustment	\$ 199,354	\$ 153,519		
Average stockholders' equity (GAAP capital)	\$ 675,295	\$ 540,225		
Average cumulative preferred stock	(125 )	(125 )		
Average non-cumulative preferred stock issued under the small business lending fund		(47,412 )		
Intangible adjustment	(199,354 )	(153,519 )		
Average tangible capital	\$ 475,816	\$ 339,169		
Average assets	\$ 5,571,354	\$ 4,455,411		
Intangible adjustment	(199,354 )	(153,519 )		
Average tangible assets	\$ 5,372,000	\$ 4,301,892		
Net Income available to common stockholders	\$ 60,162	\$ 42,150		
CDI amortization, net of tax	1,395	892		
Tangible net income (loss) available to common stockholders	\$ 61,557	\$ 43,042		
Diluted earnings per share	\$ 1.65	\$ 1.41		
Diluted tangible earnings per share	\$ 1.68	\$ 1.43		
Return on average GAAP capital	8.91	% 7.80		%
Return on average tangible capital	12.94	% 12.69		%
Return on average assets	1.08	% 0.95		%
Return on average tangible assets	1.15	% 1.00		%

Return on average tangible capital is tangible net income available to common stockholders (annualized) expressed as a percentage of average tangible capital. Return on average tangible assets is tangible net income available to common stockholders (annualized) expressed as a percentage of average tangible assets.

## LOAN QUALITY/PROVISION AND ALLOWANCE FOR LOAN LOSSES

The Corporation's primary lending focus is small business and middle market commercial, commercial real estate, residential real estate and consumer, which results in portfolio diversification. Commercial loans are individually underwritten and judgmentally risk rated. They are periodically monitored and prompt corrective actions are taken on deteriorating loans. Retail loans are typically underwritten with statistical decision-making tools and are managed throughout their life cycle on a portfolio basis.

## Loan Quality

The quality and amount of non-performing loans may increase or decrease going forward as a result of acquisitions, organic portfolio growth, problem loan recognition and resolution through collections, sales or charge offs. The

performance of any loan can be affected by external factors such as economic conditions, or internal factors specific to a particular borrower, such as the actions of a customer's management.

At December 31, 2014, non-performing loans totaled \$50,781,000 and included \$5,674,000 of non-accrual loans acquired in the Community transaction. The increase in non-performing loans due to the acquired non-accruals was offset by a \$13,287,000 decrease in non-accruals in the existing portfolio, contributing to a \$8,669,000 decrease in non-performing loans from December 31, 2013. Non-accrual loans totaled \$48,789,000 at December 31, 2014. The Corporation's coverage ratio of allowance for loan losses to non-accrual loans increased from 120.3 percent at December 31, 2013 to 131.1 percent at December 31, 2014. See additional information in the "Provision and Allowance for Loan Losses" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

Other real estate owned totaling \$19,293,000 at December 31, 2014, declined \$2,953,000 during the twelve month period despite the addition of \$6,662,000 of real estate assets acquired in the Community acquisition. For other real estate owned, current appraisals are obtained to determine fair value as management continues to aggressively market these real estate assets.

Accruing loans delinquent 90 or more days at December 31, 2014 increased \$3,313,000 to \$4,663,000 from the December 31, 2013 balance of \$1,350,000. Commercial and industrial loans 90+ days delinquent and accruing increased to \$2,985,000 at December 31, 2014 from the December 31, 2013 balance of zero. Renegotiated loans decreased \$1,056,000 as the amount of new troubled debt restructurings during the period was outpaced by the continued performance of troubled debt restructurings from prior periods.



Table of Contents

## PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Commercial impaired loans include all non-accrual loans, loans accounted for under ASC 310 as well as substandard, doubtful and loss grade loans that were still accruing but deemed impaired according to guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more and troubled debt restructurings.

A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected substantially within the contractual terms of the note. At December 31, 2014, commercial impaired loans totaled \$116,223,000, including \$17,027,000 in loans acquired in the Community transaction. At December 31, 2014, a specific allowance for losses was not deemed necessary for commercial impaired loans totaling \$102,793,000 as there was no identified loss on these credits. An allowance of \$2,769,000 was recorded for the remaining balance of these impaired loans totaling \$13,430,000 and is included in the Corporation's allowance for loan losses.

At December 31, 2014, non-performing assets, which includes non-accrual loans, renegotiated loans, and other real estate owned, plus loans 90-days delinquent, totaled \$74,737,000; a decrease of \$8,309,000 from December 31, 2013 as noted in the table below.

	December 31, 2014	December 31, 2013
(Dollars in Thousands)		
Non-Performing Assets:		
Non-accrual loans	\$48,789	\$56,402
Renegotiated loans	1,992	3,048
Non-performing loans (NPL)	50,781	59,450
Other real estate owned	19,293	22,246
Non-performing assets (NPA)	70,074	81,696
90+ days delinquent and still accruing	4,663	1,350
NPAs & 90+ days delinquent	\$74,737	\$83,046
Impaired loans (includes substandard, doubtful and loss)	\$116,223	\$119,755

The composition of non-performing assets and 90-day delinquent loans is reflected in the following table.

	December 31, 2014	December 31, 2013
(Dollars in Thousands)		
Non Performing Assets and 90+ Days Delinquent:		
Commercial and industrial loans	\$10,033	\$9,317
Agricultural production financing and other loans to farmers	5,800	30
Real estate loans		
Construction	8,363	12,730
Commercial and farmland	30,400	43,229
Residential	17,079	15,340
Home equity	2,802	1,977
Individual's loans for household and other personal expenditures	260	259
Lease financing receivables, net of unearned income		

Other loans		164
Non performing assets plus 90+ days delinquent	\$74,737	\$83,046

Although the Corporation believes its underwriting and loan review procedures are appropriate for the various kinds of loans it makes, its results of operations and financial condition could be adversely affected in the event the quality of its loan portfolio declines. Deterioration in the economic environment including residential and commercial real estate values may result in increased levels of loan delinquencies and credit losses.

Commercial construction and land development loans were \$207,221,000 at December 31, 2014, an increase of \$30,139,000 from December 31, 2013. At December 31, 2014, construction and land development loans represent 5.3 percent of loans compared to 4.9 percent at December 31, 2013. Management continues to closely monitor this segment of the portfolio, as well as being selective with additional exposure to this industry.

Table of Contents

## PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In 2014, total net charge offs were \$6,466,000, a decrease of \$1,678,000 from 2013 and \$13,600,000 from 2012. The Corporation incurred four commercial loan charge offs of \$1 million and greater in 2014 totaling \$8,011,000. The largest charge offs, totaling \$4,794,000, were incurred on a single commercial and agricultural loan relationship. Five recoveries of over \$500,000, totaling \$3,672,000, were recognized during the year. Commercial and farm real estate accounted for \$3,820,000, or 59.1 percent of total net charge offs, compared to \$3,935,000 and 48.3 percent in 2013. The 2014 commercial and farm real estate net charge offs included a single commercial real estate charge off totaling \$2,038,000. At December 31, 2014, commercial and farm real estate loans accounted for 42.6 percent of total loans.

The table below represents loan loss experience for the years indicated.

(Dollars in Thousands)	2014	2013	2012		
Allowance for loan losses:					
Balance at January 1	\$67,870	\$69,366	\$70,898		
Charge offs	17,382	18,134	27,272		
Recoveries	10,916	9,990	7,206		
Net charge offs	6,466	8,144	20,066		
Provision for loan losses	2,560	6,648	18,534		
Balance at December 31	\$63,964	\$67,870	\$69,366		
Ratio of net charge offs during the period to average loans outstanding during the period	0.17	% 0.27	% 0.71	%	
Ratio of allowance to non-accrual loans	131.10	% 120.30	% 129.90	%	

The distribution of the net charge offs for the years indicated is provided in the following table.

(Dollars in Thousands)	December 31, 2014	December 31, 2013	December 31, 2012		
Net charge offs:					
Commercial and industrial loans	\$865	\$1,932	\$6,133		
Agricultural production financing and other farm loans	970	(317)	(42)	)	)
Real estate loans					
Construction	(509)	) 6	271		
Commercial and farmland	3,820	3,935	8,399		
Residential	633	1,347	3,052		
Home equity	453	1,247	1,310		
Individuals loans for household and other personal expenditures	280	67	435		
Lease financing receivables, net of unearned income	(22)	) 11	32		
Other loans	(24)	) (84)	) 476		
Total net charge offs	\$6,466	\$8,144	\$20,066		

## Provision and Allowance for Loan Losses

The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The provision for loan losses in 2014, 2013 and 2012 were \$2,560,000, \$6,648,000 and \$18,534,000, respectively, showing significant year over year declines.

The amount actually provided for loan losses in any period may be greater than or less than net loan losses, based on management's judgment as to the appropriate level of the allowance for loan losses. The determination of the provision amount and the adequacy of the allowance in any period is based on management's continuing review and evaluation of the loan portfolio, including and internally administered loan "watch" list and an independent review. The evaluation takes into consideration identified credit problems, managements judgment as to the impact of current economic conditions on the portfolio and the possibility of losses inherent in the loan portfolio that are not specifically identified.

See the "CRITICAL ACCOUNTING POLICIES" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

Management believes that the allowance for loan losses is adequate to cover probable incurred losses inherent in the loan portfolio at December 31, 2014. The process for determining the adequacy of the allowance for loan losses is critical to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments to estimate the effect of uncertain matters. The allowance for loan losses considers current factors, including economic conditions and ongoing internal and external examination processes and will increase or decrease as deemed necessary to ensure the allowance remains adequate. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, loan mix and collateral values. Management continually evaluates the commercial loan portfolio by including consideration of specific borrower cash flow analysis and estimated collateral values, types and amounts on non-performing loans, past and anticipated loan loss experience, changes in the composition of the loan portfolio, and the current condition and amount of loans outstanding.

Table of Contents

## PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In conformance with ASC 805 and ASC 820, loans purchased after December 31, 2008 are recorded at the acquisition date fair value. Such loans are only included in the allowance to the extent a specific impairment is identified that exceeds the fair value adjustment on an impaired loan or the historical loss and environmental factor analysis indicates losses inherent in a purchased portfolio exceeds the fair value adjustment on the portion of the purchased portfolio not deemed impaired.

At December 31, 2014, the allowance for loan losses was \$63,964,000 a decrease of \$3,906,000 from December 31, 2013. As a percent of loans, the allowance decreased to 1.6 percent at December 31, 2014 from 1.9 percent at December 31, 2013. The decrease in the ratio of allowance to loans was due in part to a \$141,321,000 net increase in loans resulting primarily from the acquisition of Community. During 2014, the specific reserves against impaired loans increased by \$1,186,000, and the allowance decreased by \$5,092,000 in the ASC 450, Contingencies, allocation for loans not deemed impaired. Not included in the allowance for loan losses is the remaining fair value discount on acquired loans of \$39,986,000 and \$46,112,000 as of December 31, 2014 and 2013, respectively.

Loans are generally secured by specific items of collateral, including real property and business assets. Allowable methods for determining the amount of impairment include estimating fair value using the fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. The fair value of real estate is generally determined based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. Updated "as is" or "liquidation value" appraisals are obtained as individual circumstances and or market conditions warrant. Partially charged off loans measured for impairment based on their collateral value are generally not returned to performing status subsequent to receiving updated appraisals or restructure of the loan. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically ascertained by assessing, either singularly or some combination of, asset appraisals, accounts receivable aging reports, inventory listings and or customer financial statements. Both appraised values and values based on borrower's financial information are discounted as considered appropriate based on age and quality of the information and current market conditions.

Loans deemed impaired according to guidance set forth in ASC 310 are evaluated during problem loan meetings held within each reporting period by a special assets management team. Loan collateral and customer financial information are reviewed and the level of impairment is assessed to determine appropriate and accurate reserve and or charge off amounts. Loans or portions of loans are charged off when they are considered uncollectible and of such little value that their continuance as an asset is not warranted. It is the Corporation's policy to recognize losses promptly to prevent overstatement of assets, earnings and capital.

The following table summarizes loan loss reserves by loan segment for the periods ended December 31, 2014 and 2013.

(Dollars in Thousands)	December 31, 2014					Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	
Allowance Balances:						
Individually evaluated for impairment	\$1,455	\$470		\$194		\$2,119
Collectively evaluated for impairment	27,369	18,207	\$2,658	12,958	\$3	61,195
		650				650

## Loans acquired with deteriorated credit quality

	December 31, 2013					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Total allowance for loan losses	\$28,824	\$19,327	\$2,658	\$13,152	\$3	\$63,964
Allowance Balances:						
Individually evaluated for impairment	\$585	\$763		\$6		\$1,354
Collectively evaluated for impairment	26,493	22,208	\$2,515	15,071		66,287
Loans acquired with deteriorated credit quality	98	131				229
Total allowance for loan losses	\$27,176	\$23,102	\$2,515	\$15,077		\$67,870

The historical loss allocation for loans not deemed impaired according to ASC 310 is the product of the volume of loans within the non-impaired criticized and non-criticized risk grade classifications, each segmented by call code, and the historical loss factor for each respective classification and call code segment. The historical loss factors are based upon actual loss experience within each risk and call code classification. The historical look back period for non-criticized loans is the most recent rolling-four-quarter average and aligns with the look back period for non-impaired criticized loans. Each of the rolling-four-quarter periods used to obtain the average, includes all charge offs for the previous twelve-month period; therefore, the historical look back period goes back seven quarters. The resulting allocation is more reflective of current conditions. Criticized loans are grouped based on the risk grade assigned to the loan. Loans with a special mention grade are assigned a loss factor and loans with a classified grade, but not impaired, are assigned a separate loss factor. The loss factor computation for this allocation includes a segmented historical loss migration analysis of non-impaired loans, by risk grade, to charge off. The decrease in the allowance as a percent of originated loans reflected the impact of the stabilizing economic environment on the Corporation's loan portfolio, resulting in improved credit quality and fewer charge offs. Given the continued credit improvement and the resulting decrease in net charge offs, the historical loss component adjusted downward in 2014.

Table of Contents

PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In addition to the specific reserves and historical loss components of the allowance, consideration is given to various environmental factors to help ensure that losses inherent in the portfolio are reflected in the allowance for loan losses. The environmental component adjusts the historical loss allocations for commercial and consumer loans to reflect relevant current conditions that, in management's opinion, have an impact on loss recognition. Environmental factors that management reviews in the analysis include: National and local economic trends and conditions; trends in growth in the loan portfolio and growth in higher risk areas; levels of, and trends in, delinquencies and non-accruals; experience and depth of lending management and staff; adequacy of, and adherence to, lending policies and procedures including those for underwriting; industry concentrations of credit; and adequacy of risk identification systems and controls through the internal loan review and internal audit processes. Each environmental factor receives an individual qualitative allocation that, in management's opinion, reflects losses inherent in the portfolio that are not reflected in the historical loss components of the allowance. As the economic environment has seen improvement during recent periods, management believes losses inherent in the portfolio may not be immediately apparent for specific identification. At December 31, 2014, the allocation related to environmental considerations totaled \$49,223,000, or 1.5 percent of originated loans compared to \$48,210,000 or 1.6 percent of originated loans at December 31, 2013.

The Corporation's primary market areas for lending are central Indiana, northwestern Indiana, northeastern Illinois, and central Ohio. When evaluating the adequacy of the allowance, consideration is given to this regional geographic concentration and the closely associated effect changing economic conditions have on the Corporation's customers. In management's opinion, the allowance for loan losses at December 31, 2014 is reflective of both the banking environment within the Corporation's footprint and the Corporation's recent loan and loss trends.

GOODWILL

Goodwill is reviewed annually for impairment. The Corporation completed its most recent annual goodwill impairment test as of October 1, 2014 and concluded, based on current events and circumstances, goodwill is not impaired. On November 7, 2014, the Corporation recorded approximately \$13,776,000 of goodwill associated with the Community acquisition. Additionally, on November 12, 2013, the Corporation recorded approximately \$47,573,000 of goodwill associated with the acquisition of CFS.

LIQUIDITY

Liquidity management is the process by which the Corporation ensures that adequate liquid funds are available for the holding company and its subsidiaries. These funds are necessary in order to meet financial commitments on a timely basis. These commitments include withdrawals by depositors, funding credit obligations to borrowers, paying dividends to stockholders, paying operating expenses, funding capital expenditures, and maintaining deposit reserve requirements. Liquidity is monitored and closely managed by the asset/liability committee.

The Corporation's liquidity is dependent upon the receipt of dividends from the Bank, which are subject to certain regulatory limitations and access to other funding sources. Liquidity of the Bank is derived primarily from core deposit growth, principal payments received on loans, the sale and maturity of investment securities, net cash provided by operating activities, and access to other funding sources.

The principal source of asset-funded liquidity is investment securities classified as available for sale, the market values of which totaled \$549,543,000 at December 31, 2014, an increase of \$13,342,000, or 2.5 percent, from December 31, 2013. Securities classified as held to maturity that are maturing within a short period of time can also be

a source of liquidity. Securities classified as held to maturity and that are maturing in one year or less totaled \$6,258,000 at December 31, 2014. In addition, other types of assets such as cash and interest-bearing deposits with other banks, federal funds sold and loans maturing within one year are sources of liquidity.

The most stable source of liability-funded liquidity for both the long-term and short-term is deposit growth and retention in the core deposit base. Federal funds purchased and securities sold under agreements to repurchase are also considered a source of liquidity. In addition, Federal Home Loan Bank ("FHLB") advances are utilized as a funding source. At December 31, 2014, total borrowings from the FHLB were \$145,264,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at December 31, 2014 was \$399,188,000.

On November 1, 2013, the Corporation completed the private issuance and sale to four institutional investors of an aggregate of \$70 million of debt comprised of (a) 5.00 percent Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million (the "Senior Debt") and (b) 6.75 percent Fixed-to-Floating Rate Subordinated Notes due 2028 in the aggregate principal amount of \$65 million (the "Subordinated Debt"). The Senior Debt agreement contains certain customary representations and warranties and financial and negative covenants. As of December 31, 2014, the Corporation was in compliance with these covenants. The net proceeds of the placement were used to pay off the Corporation's \$55 million credit facility with Bank of America, N.A. which was scheduled to mature on February 15, 2015.

Additionally, on April 11, 2014, the Corporation entered into a line of credit agreement with U.S. Bank, N.A. with a maximum borrowing capacity of \$20 million. As of December 31, 2014, there was no outstanding balance on the line of credit. Interest is payable quarterly based on one-month LIBOR plus 2.00 percent. The line of credit has a quarterly facility fee of 0.25 percent on the unused balance. The maturity date for the line of credit is April 10, 2015. The line of credit agreement contains certain customary representations and warranties and financial and negative covenants. As of December 31, 2014, the Corporation was in compliance with these covenants.



Table of Contents

## PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

For further details related to the Corporation's borrowings, see Note 12. BORROWINGS, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

In the normal course of business, the Bank is a party to a number of other off-balance sheet activities that contain credit, market and operational risk that are not reflected in whole or in part in the consolidated financial statements. Such activities include: traditional off-balance sheet credit-related financial instruments, commitments under operating leases and long-term debt.

The Bank provides customers with off-balance sheet credit support through loan commitments and standby letters of credit. Summarized credit-related financial instruments at December 31, 2014 are as follows:

(Dollars in Thousands)	December 31, 2014
Amounts of Commitments:	
Loan commitments to extend credit	\$ 1,617,552
Standby letters of credit	52,655
	\$ 1,670,207

Since many of the commitments are expected to expire unused or be only partially used, the total amount of unused commitments in the preceding table does not necessarily represent future cash requirements.

In addition to owned banking facilities, the Corporation has entered into a number of long-term leasing arrangements to support ongoing activities. The required payments under such commitments and borrowings at December 31, 2014 are as follows:

(Dollars in Thousands)	2015	2016	2017	2018	2019	2020 and after	Total
Operating leases	\$ 2,778	\$ 2,207	\$ 1,514	\$ 844	\$ 537	\$ 2,724	\$ 10,604
Federal funds purchased	15,381						15,381
Securities sold under repurchase agreements	124,539						124,539
Federal Home Loan Bank advances	30,780	41,225	15,018	25,637	12,503	20,101	145,264
Subordinated debentures and term loans	108					126,702	126,810
Total	\$ 173,586	\$ 43,432	\$ 16,532	\$ 26,481	\$ 13,040	\$ 149,527	\$ 422,598

## INTEREST SENSITIVITY AND DISCLOSURES ABOUT MARKET RISK

Asset and liability management has been an important factor in the Corporation's ability to record consistent earnings growth through periods of interest rate volatility and product deregulation. Management and the Board of Directors monitor the Corporation's liquidity and interest sensitivity positions at regular meetings to review how changes in interest rates may affect earnings. Decisions regarding investment and the pricing of loan and deposit products are made after analysis of reports designed to measure liquidity, rate sensitivity, the Corporation's exposure to changes in net interest income given various rate scenarios and the economic and competitive environments.

It is the objective of the Corporation to monitor and manage risk exposure to net interest income caused by changes in interest rates. It is the goal of the Corporation's asset and liability management function to provide optimum and stable net interest income. To accomplish this, management uses two asset liability tools. GAP/Interest rate sensitivity reports and net interest income simulation modeling are constructed, presented and monitored quarterly. Management believes that the Corporation's liquidity and interest sensitivity position at December 31, 2014, remained adequate to meet the Corporation's primary goal of achieving optimum interest margins while avoiding undue interest rate risk.

Table of Contents

## PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following table presents the Corporation's interest rate sensitivity analysis as of December 31, 2014.

(Dollars in Thousands)	December 31, 2014				
	1-180 Days	181-365 Days	1-5 Years	Beyond 5 Years	Total
<b>Rate-Sensitive Assets:</b>					
Interest-bearing deposits	\$47,520				\$47,520
Investment securities	79,709	\$86,260	\$392,530	\$622,132	1,180,631
Loans	2,102,140	364,716	1,004,666	453,343	3,924,865
Federal Reserve and Federal Home Loan Bank stock			41,353		41,353
<b>Total rate-sensitive assets</b>	<b>\$2,229,369</b>	<b>\$450,976</b>	<b>\$1,438,549</b>	<b>\$1,075,475</b>	<b>\$5,194,369</b>
<b>Rate-Sensitive Liabilities:</b>					
Interest-bearing deposits	\$2,708,756	\$187,611	\$478,987	\$194,481	\$3,569,835
Federal funds purchased	15,381				15,381
Securities sold under repurchase agreements	124,539				124,539
Federal Home Loan Bank advances	36,328	27,052	69,260	12,624	145,264
Subordinated debentures and term loans	56,702			70,108	126,810
<b>Total rate-sensitive liabilities</b>	<b>\$2,941,706</b>	<b>\$214,663</b>	<b>\$548,247</b>	<b>\$277,213</b>	<b>\$3,981,829</b>
Interest rate sensitivity gap by period	\$ (712,337 )	\$ 236,313	\$ 890,302	\$ 798,262	
Cumulative rate sensitivity gap	\$ (712,337 )	\$ (476,024 )	\$ 414,278	\$ 1,212,540	
Cumulative rate sensitivity gap ratio					
at December 31, 2014	75.8	% 84.9	% 111.2	% 130.5	%
at December 31, 2013	104.6	% 106.4	% 113.0	% 124.5	%

The Corporation had a cumulative positive gap of \$476,024,000 in the one-year horizon at December 31, 2014 or 8.17 percent of total assets.

The Corporation places its greatest credence in net interest income simulation modeling. The above GAP/Interest rate sensitivity report is believed by the Corporation's management to have two major shortfalls. The GAP/Interest rate sensitivity report fails to precisely gauge how often an interest rate sensitive product reprices, nor is it able to measure the magnitude of potential future rate movements.

Net interest income simulation modeling, or earnings-at-risk, measures the sensitivity of net interest income to various interest rate movements. The Corporation's asset liability process monitors simulated net interest income under three separate interest rate scenarios; base, rising and falling. Estimated net interest income for each scenario is calculated over a twelve-month horizon. The immediate and parallel changes to the base case scenario used in the model are presented below. The interest rate scenarios are used for analytical purposes and do not necessarily represent management's view of future market movements. Rather, these are intended to provide a measure of the degree of volatility interest rate movements may introduce into the earnings of the Corporation.

The base scenario is highly dependent on numerous assumptions embedded in the model, including assumptions related to future interest rates. While the base sensitivity analysis incorporates management's best estimate of interest rate and balance sheet dynamics under various market rate movements, the actual behavior and resulting earnings impact will likely differ from that projected. For certain assets, the base simulation model captures the expected

prepayment behavior under changing interest rate environments. Assumptions and methodologies regarding the interest rate or balance behavior of indeterminate maturity products, such as savings, money market, NOW and demand deposits, reflect management's best estimate of expected future behavior.

Table of Contents

## PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of December 31, 2014, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In the current rate environment, many driver rates are at or near historical lows, thus total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management have the following results:

Driver Rates	At December 31, 2014	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	0
Federal Funds	200	0
One-Year CMT	200	(15)
Three-Year CMT	200	(83)
Five-Year CMT	200	(100)
CD's	200	(23)
FHLB	200	(43)

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below based upon the Corporation's rate sensitive assets and liabilities at December 31, 2014. The net interest income shown represents cumulative net interest income over a twelve-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

(Dollars in Thousands)	At December 31, 2014		
	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net Interest Income	\$180,175	\$192,164	\$175,118
Variance from Base		\$11,989	\$(5,057)
Percent of Change from Base		6.65	% (2.81)

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of December 31, 2013, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In addition, total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management in the base simulation are as follows:

Driver Rates	At December 31, 2013	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	0
Federal Funds	200	0
One-Year CMT	200	(5)
Three-Year CMT	200	(50)
Five-Year CMT	200	(100)
CD's	200	(20)
FHLB	200	(33)

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below. The net interest income shown represents cumulative net interest income over a twelve-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

	At December 31, 2013		
(Dollars in Thousands)	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net Interest Income	\$ 179,646	\$ 190,736	\$ 175,238
Variance from Base		\$ 11,090	\$ (4,408 )
Percent of Change from Base		6.17	% (2.45 )%

Table of Contents

## PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## EARNING ASSETS

The following table presents the earning asset mix as of December 31, 2014, and 2013. Earnings assets increased by \$374,226,000. Loans and loans held for sale and investment securities increased by \$294,360,000 and \$85,052,000, respectively. The four largest loan segments that experienced increases were commercial and industrial, commercial and farmland, home equity and residential. A slight decrease was noted in agricultural production financing and other loans to farmers. The two most significant earning assets acquire in the Community transaction were loans of \$145,064,000 and investment securities available for sale of \$76,807,000.

	December 31, 2014	December 31, 2013
(Dollars in Thousands)		
Interest-bearing time deposits	\$47,520	\$55,069
Investment securities available for sale	549,543	536,201
Investment securities held to maturity	631,088	559,378
Mortgage loans held for sale	7,235	5,331
Loans	3,924,865	3,632,409
Federal Reserve and Federal Home Loan Bank stock	41,353	38,990
	\$5,201,604	\$4,827,378

## DEPOSITS AND BORROWINGS

The table below reflects the level of deposits and borrowed funds (federal funds purchased, repurchase agreements; FHLB advances; subordinated debentures and term loans) based on year-end levels at December 31, 2014 and 2013.

	December 31, 2014	December 31, 2013
(Dollars in Thousands)		
Deposits	\$4,640,694	\$4,231,468
Federal funds purchased	15,381	125,645
Securities sold under repurchase agreements	124,539	148,672
Federal Home Loan Bank advances	145,264	122,140
Subordinated debentures and term loans	126,810	126,807
	\$5,052,688	\$4,754,732

The Corporation has leveraged its capital position with FHLB advances, as well as repurchase agreements, which are pledged against acquired investment securities as collateral for the borrowings. Further discussion regarding FHLB advances is included in Management's Discussion and Analysis of Financial Condition and Results of Operations under the heading "LIQUIDITY". Additionally, the interest rate risk is included as part of the Corporation's interest simulation discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K under the heading "INTEREST SENSITIVITY AND DISCLOSURES ABOUT MARKET RISK".





Table of Contents

PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

INCOME TAXES

Income tax expense totaled \$21,390,000 for 2014 compared to \$14,677,000 for 2013. The Corporation's federal statutory income tax rate is 35 percent and its state tax rate varies from 0 to 9.5 percent depending on the state in which the subsidiary company is domiciled. The Corporation's effective tax rate is lower than the blended effective statutory federal and state rates primarily due to the Corporation's income on tax-exempt securities and loans, income generated by the subsidiaries domiciled in a state with no state or local income tax, income tax credits generated from investments in affordable housing projects, tax-exempt earnings from bank-owned life insurance contracts and reduced state taxes, resulting from the effect of state income apportionment. The reconciliation of federal statutory to actual tax expense is shown in Note 22, INCOME TAX, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

The Corporation's tax asset, deferred and receivable decreased from \$56,614,000 at December 31, 2013 to \$41,960,000 at December 31, 2014. In addition, the Corporation's net deferred tax asset has decreased from \$55,785,000 at December 31, 2013 to \$39,392,000 at December 31, 2014. The \$16,393,000 decrease in the Corporation's net deferred tax asset was due to a combination of a decrease in deferred tax assets and an increase in deferred tax liabilities. The largest deferred tax asset decreases were associated with accounting for loans, other than temporary impairment on securities, and other real estate owned in the amounts of \$3,669,000, \$3,261,000 and \$1,988,000, respectively. Partially offsetting these deferred tax asset decreases was the \$2,180,000 net change in the shift of the accounting for pensions and other employee benefits from a deferred tax liability to a deferred tax asset. Finally, the largest deferred tax liability increase of \$7,742,000 resulted from the accounting for unrealized gains on available for sale securities.

The Corporation has recorded a valuation allowance of \$17,568,000 related to deferred state taxes as it does not anticipate having future state taxable income sufficient to fully utilize the deferred state tax asset. This is primarily due to the Corporation's current tax structure as noted above.

INFLATION

Changing prices of goods, services and capital affect the financial position of every business enterprise. The level of market interest rates and the price of funds loaned or borrowed fluctuate due to changes in the rate of inflation and various other factors, including government monetary policy.

Fluctuating interest rates affect the Corporation's net interest income and loan volume. As the inflation rate increases, the purchasing power of the dollar decreases. Those holding fixed-rate monetary assets incur a loss, while those holding fixed-rate monetary liabilities enjoy a gain. The nature of a financial holding company's operations is such that there will generally be an excess of monetary assets over monetary liabilities, and, thus, a financial holding company will tend to suffer from an increase in the rate of inflation and benefit from a decrease.

OTHER

The Securities and Exchange Commission maintains a website that contains reports, proxy and information statements and other information regarding registrants that file electronically with the Commission, including the Corporation, and that address is [www.sec.gov](http://www.sec.gov).



Table of Contents

PART II: ITEM 7. AND ITEM 7A. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

The quantitative and qualitative disclosures about market risk information are presented in the “INTEREST SENSITIVITY AND DISCLOSURES ABOUT MARKET RISK” section of Management’s Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

Report of Independent Registered Public Accounting Firm

Audit Committee, Board of Directors and Stockholders  
First Merchants Corporation  
Muncie, Indiana

We have audited the accompanying consolidated balance sheets of First Merchants Corporation (Corporation) as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2014. The Corporation's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audits included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Merchants Corporation as of December 31, 2014 and 2013, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), First Merchants Corporation's internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control-Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 27, 2015, expressed an unqualified opinion on the effectiveness of the Corporation's internal control over financial reporting.

BKD, LLP  
Indianapolis, Indiana  
February 27, 2015

Table of ContentsPART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA  
CONSOLIDATED FINANCIAL STATEMENTS

## CONSOLIDATED BALANCE SHEETS

	December 31, 2014	December 31, 2013
(Dollars in Thousands, Except Share Data)		
<b>ASSETS</b>		
Cash and cash equivalents	\$118,616	\$109,434
Interest-bearing time deposits	47,520	55,069
Investment securities available for sale	549,543	536,201
Investment securities held to maturity (fair value of \$647,723 and \$560,847)	631,088	559,378
Loans held for sale	7,235	5,331
Loans	3,924,865	3,632,409
Less: Allowance for loan losses	(63,964 )	(67,870 )
Net loans	3,860,901	3,564,539
Premises and equipment	77,691	74,454
Federal Reserve and Federal Home Loan Bank stock	41,353	38,990
Interest receivable	19,984	18,672
Core deposit intangibles	16,031	13,818
Goodwill	202,724	188,948
Cash surrender value of life insurance	169,424	164,571
Other real estate owned	19,293	22,246
Tax asset, deferred and receivable	41,960	56,614
Other assets	20,764	28,997
<b>TOTAL ASSETS</b>	<b>\$5,824,127</b>	<b>\$5,437,262</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing	\$1,070,859	\$930,772
Interest-bearing	3,569,835	3,300,696
<b>Total Deposits</b>	<b>4,640,694</b>	<b>4,231,468</b>
Borrowings:		
Federal funds purchased	15,381	125,645
Securities sold under repurchase agreements	124,539	148,672
Federal Home Loan Bank advances	145,264	122,140
Subordinated debentures and term loans	126,810	126,807
<b>Total Borrowings</b>	<b>411,994</b>	<b>523,264</b>
Interest payable	3,201	1,771
Other liabilities	41,411	45,836
<b>Total Liabilities</b>	<b>5,097,300</b>	<b>4,802,339</b>
<b>COMMITMENTS AND CONTINGENT LIABILITIES</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Cumulative Preferred Stock, \$1,000 par value, \$1,000 liquidation value:		
Authorized - 600 shares		
Issued and outstanding - 125 shares	125	125
Common Stock, \$.125 stated value:		
Authorized - 50,000,000 shares		
Issued and outstanding - 37,669,948 and 35,921,761 shares	4,709	4,490

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Additional paid-in capital	431,220	393,783
Retained earnings	292,403	242,935
Accumulated other comprehensive loss	(1,630 )	(6,410 )
Total Stockholders' Equity	726,827	634,923
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$5,824,127	\$5,437,262

See notes to consolidated financial statements.

Table of ContentsPART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA  
CONSOLIDATED FINANCIAL STATEMENTS

## CONSOLIDATED STATEMENTS OF INCOME

	December 31, 2014	December 31, 2013	December 31, 2012
(Dollars in Thousands, Except Share Data)			
<b>INTEREST INCOME</b>			
Loans receivable:			
Taxable	\$ 172,039	\$ 142,752	\$ 146,745
Tax-exempt	327	393	480
Investment securities:			
Taxable	19,882	15,214	17,027
Tax-exempt	14,383	10,829	10,189
Deposits with financial institutions	124	158	100
Federal Reserve and Federal Home Loan Bank stock	2,124	1,488	1,408
Total Interest Income	208,879	170,834	175,949
<b>INTEREST EXPENSE</b>			
Deposits	11,678	10,053	14,800
Federal funds purchased	177	102	69
Securities sold under repurchase agreements	529	787	907
Federal Home Loan Bank advances	2,842	2,096	2,624
Subordinated debentures, revolving credit lines and term loans	6,616	3,531	5,213
Total Interest Expense	21,842	16,569	23,613
<b>NET INTEREST INCOME</b>	187,037	154,265	152,336
Provision for loan losses	2,560	6,648	18,534
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	184,477	147,617	133,802
<b>OTHER INCOME</b>			
Service charges on deposit accounts	15,747	12,400	11,587
Fiduciary activities	8,966	8,594	7,891
Other customer fees	15,699	11,866	11,233
Commission income	7,411	7,141	6,224
Earnings on cash surrender value of life insurance	3,659	2,613	3,418
Net gains and fees on sales of loans	4,899	7,511	10,628
Net realized gains on sales of available for sale securities	3,581	487	2,389
Gain on FDIC modified whole bank transaction			9,124
Other income	5,705	4,197	1,808
Total Other Income	65,667	54,809	64,302
<b>OTHER EXPENSES</b>			
Salaries and employee benefits	96,499	85,413	79,398
Net occupancy	13,831	10,291	10,186
Equipment	9,337	7,737	7,201
Marketing	3,464	2,236	2,158
Outside data processing fees	7,315	5,591	5,656
Printing and office supplies	1,565	1,340	1,169
Core deposit amortization	2,445	1,649	1,927
FDIC assessments	3,738	2,862	3,509

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Other real estate owned and foreclosure expenses	8,043	6,661	8,178
Professional and other outside services	8,116	8,297	6,228
Other expenses	14,239	11,142	11,505
Total Other Expenses	168,592	143,219	137,115
INCOME BEFORE INCOME TAX	81,552	59,207	60,989
Income tax expense	21,390	14,677	15,867
NET INCOME	60,162	44,530	45,122
Preferred stock dividends		(2,380	) (4,539
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$60,162	\$42,150	\$40,583
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS PER SHARE:			
Basic	\$1.66	\$1.42	\$1.42
Diluted	\$1.65	\$1.41	\$1.41

See notes to consolidated financial statements.



Table of ContentsPART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA  
CONSOLIDATED FINANCIAL STATEMENTS

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in Thousands)	December 31, 2014	December 31, 2013	December 31, 2012
Net income	\$60,162	\$44,530	\$45,122
Other comprehensive income (loss) net of tax:			
Unrealized holding gain (loss) on securities available for sale arising during the period, net of tax of \$8,001, \$6,841, and \$654	14,860	(12,705 )	1,214
Unrealized loss on securities transferred to held-to-maturity, net of tax of \$0, \$1,786, and \$0		(3,316 )	
Unrealized gain (loss) on securities available for sale for which a portion of an other than temporary impairment has been recognized in income, net of tax of \$995, \$767, and \$56	1,847	1,425	(104 )
Unrealized gain (loss) on cash flow hedges arising during the period, net of tax of \$1,397, \$831, and \$514	(2,599 )	1,543	(952 )
Reclassification adjustment for net losses (gains) included in net income net of tax of \$760, \$157, and \$759	(1,410 )	291	(1,413 )
Defined benefit pension plans, net of tax of \$4,264, \$6,382, and \$346			
Net gain (loss) arising during period	(7,580 )	10,704	(577 )
Amortization of prior service cost	(338 )	1,147	(65 )
	4,780	(911 )	(1,897 )
Comprehensive income	\$64,942	\$43,619	\$43,225

See notes to consolidated financial statements.

Table of ContentsPART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA  
CONSOLIDATED FINANCIAL STATEMENTS

## CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Dollars in Thousands, Except Share Data)	Preferred		Common Stock			Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount	Amount				
Balances, December 31, 2011	90,908	\$90,908	28,559,707	\$3,570	\$254,874	\$168,717	\$ (3,602 )	\$514,467	
Comprehensive income									
Net income						45,122		45,122	
Other comprehensive income (loss), net of tax							(1,897 )	(1,897 )	
Cash dividends on common stock (\$.10 per share)						(2,903 )		(2,903 )	
Cash dividends on preferred stock under small business lending fund						(4,539 )		(4,539 )	
Share-based compensation			86,325	11	1,481			1,492	
Stock issued under employee benefit plans			41,867	5	444			449	
Stock issued under dividend reinvestment and stock purchase plan			15,709	2	200			202	
Stock options exercised			10,500	1	77			78	
Stock redeemed			(21,492 )	(2 )	(233 )			(235 )	
Balances, December 31, 2012	90,908	\$90,908	28,692,616	\$3,587	\$256,843	\$206,397	\$ (5,499 )	\$552,236	
Comprehensive income									
Net income						44,530		44,530	
Other comprehensive income (loss), net of tax							(911 )	(911 )	
Cash dividends on common stock (\$.18 per share)						(5,612 )		(5,612 )	
Cash dividends on preferred stock under small business lending fund						(2,380 )		(2,380 )	
Preferred stock redemption under small business lending fund	(90,783 )	(90,783 )						(90,783 )	
			7,079,457	885	134,757			135,642	

Issuance of common stock related to acquisition								
Share-based compensation			116,978	15	1,758			1,773
Stock issued under employee benefit plans			33,451	4	475			479
Stock issued under dividend reinvestment and stock purchase plan			18,449	2	323			325
Stock options exercised			13,750	2	113			115
Stock redeemed			(32,940)	(5)	(486)			(491)
Balances, December 31, 2013	125	\$125	35,921,761	\$4,490	\$393,783	\$242,935	\$(6,410)	\$634,923
Comprehensive income								
Net income						60,162		60,162
Other comprehensive income, net of tax							4,780	4,780
Cash dividends on common stock (\$.29 per share)						(10,694)		(10,694)
Issuance of common stock related to acquisition			1,574,298	197	34,784			34,981
Share-based compensation			132,446	17	2,160			2,177
Stock issued under employee benefit plans			26,547	3	475			478
Stock issued under dividend reinvestment and stock purchase plan			24,556	3	520			523
Stock options exercised			41,249	5	559			564
Stock redeemed			(50,909)	(6)	(1,061)			(1,067)
Balances, December 31, 2014	125	\$125	37,669,948	\$4,709	\$431,220	\$292,403	\$(1,630)	\$726,827

See notes to consolidated financial statements.

Table of ContentsPART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA  
CONSOLIDATED FINANCIAL STATEMENTS

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	December 31, 2014	December 31, 2013	December 31, 2012
(Dollars in Thousands)			
Cash Flow From Operating Activities:			
Net income	\$60,162	\$44,530	\$45,122
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	2,560	6,648	18,534
Depreciation and amortization	6,007	4,670	4,472
Change in deferred taxes	23,051	13,939	15,890
Share-based compensation	2,177	1,773	1,492
Tax benefit from stock options exercised	(60)	)	
Loans originated for sale	(222,892)	) (280,693)	) (393,565)
Proceeds from sales of Loans	220,988	297,851	389,129
Gain on acquisition			(9,124)
Gains on sales of securities available for sale	(3,581)	) (487)	) (2,389)
Change in interest receivable	(545)	) (535)	) 1,884
Change in interest payable	1,332	(364)	) (1,451)
Change in other receivable		110,032	
Other adjustments	(13,359)	) (14,233)	) 275
Net cash provided by operating activities	\$75,840	\$183,131	\$70,269
Cash Flows from Investing Activities:			
Net change in interest-bearing deposits	\$24,075	\$196,753	\$14,408
Purchases of:			
Securities available for sale	(110,936)	) (398,491)	) (139,555)
Securities held to maturity	(142,988)	) (11,145)	) (4,262)
Proceeds from sales of securities available for sale	126,575	25,222	52,350
Proceeds from maturities of:			
Securities available for sale	68,339	93,273	112,141
Securities held to maturity	69,420	78,534	68,118
Change in Federal Reserve and Federal Home Loan Bank stock	(413)	) (17)	) 246
Net change in loans	(170,109)	) (142,861)	) (123,036)
Net cash and cash equivalents received (paid) in acquisition	(10,084)	) 10,992	29,113
Proceeds from the sale of other real estate owned	14,241	12,346	4,428
Other adjustments	5,889	(2,768)	) (2,065)
Net cash provided by (used in) investing activities	\$(125,991)	\$(138,162)	\$11,886
Cash Flows from Financing Activities:			
Net change in :			
Demand and savings deposits	\$53,062	\$141,052	\$228,725
Certificates of deposit and other time deposits	127,740	(211,399)	) (142,906)
Borrowings	678,290	295,537	138,127
Repayment of borrowings	(789,563)	) (163,838)	) (271,005)
Cash dividends on common stock	(10,694)	) (5,612)	) (2,903)

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Cash dividends on preferred stock		(2,380 )	(4,539 )
Stock issued under employee benefit plans	478	479	449
Stock issued under dividend reinvestment and stock purchase plans	523	325	202
Stock options exercised	504	115	78
Tax benefit from stock options exercised	60		
Cumulative preferred stock redeemed (SBLF)		(90,783 )	
Stock redeemed	(1,067 )	(491 )	(235 )
Net cash provided by (used in) financing activities	\$59,333	\$(36,995 )	\$(54,007 )
Net Change in Cash and Cash Equivalents	9,182	7,974	28,148
Cash and Cash Equivalents, January 1	109,434	101,460	73,312
Cash and Cash Equivalents, December 31	\$118,616	\$109,434	\$101,460
Additional cash flow information:			
Interest paid	\$20,412	\$16,639	\$24,697
Income tax paid	6,209	7,578	11,738
Loans transferred to other real estate owned	4,431	7,170	4,441
Fixed assets transferred to other real estate owned	297	461	
Non-cash investing activities using trade date accounting	3,170	4,984	1,518

CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

In conjunction with the acquisitions, liabilities were assumed as follows:

	December 31, 2014	December 31, 2013	December 31, 2012
Fair value of assets acquired	\$ 280,725	\$ 1,132,231	\$ 128,923
Cash received (paid) in acquisition	(14,208 )		17,200
Net gain on acquisition			(9,124 )
Less: Common stock issued	34,981	135,642	
Liabilities assumed	\$ 231,536	\$ 996,589	\$ 136,999

See notes to consolidated financial statements.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

NOTE 1

NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies of First Merchants Corporation (the “Corporation”), and its principal wholly owned subsidiaries, First Merchants Bank, N.A. (the “Bank”), and First Merchants Insurance Services, Inc. operating as First Merchants Insurance Group (“FMIG”), conform to accounting principles generally accepted in the United States of America and reporting practices followed by the banking industry. The Bank also operates Lafayette Bank and Trust, Commerce National Bank, Community Bank of Noblesville and First Merchants Trust Company as divisions of First Merchants Bank, N.A.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Corporation is a financial holding company whose principal activity is the ownership and management of the Bank and operates in a single significant business segment. The Bank operates under a national bank charter and provides full banking services. As a national bank, the Bank is subject to the regulation of the Office of Comptroller of the Currency (“OCC”) and the Federal Deposit Insurance Corporation (“FDIC”). The OCC and the FDIC regulate or monitor virtually all areas of the Bank’s operations. The Bank must undergo regular on-site examinations by the OCC and FDIC and must submit periodic reports to both.

The Bank generates commercial, mortgage, and consumer loans and receives deposits from customers located primarily in central and northwest Indiana, northeast Illinois and central Ohio counties. The Bank’s loans are generally secured by specific items of collateral, including real property, consumer assets and business assets.

A brief description of current accounting practices and current valuation methodologies are presented below.

CONSOLIDATION of the Corporation's financial statements include the accounts of the Corporation and all its subsidiaries, after elimination of all material intercompany transactions.

BUSINESS COMBINATIONS are accounted for under the acquisition method of accounting. Under the acquisition method, assets and liabilities of the business acquired are recorded at their estimated fair values as of the date of acquisition with any excess of the cost of the acquisition over the fair value of the net tangible and intangible assets acquired recorded as goodwill. Results of operations of the acquired business are included in the income statement from the date of acquisition.

AVAILABLE FOR SALE SECURITIES are recorded at fair value on a recurring basis with the unrealized gains and losses, net of applicable income taxes, recorded in other comprehensive income. Realized gains and losses are recorded in earnings and the prior fair value adjustments are reclassified within stockholders' equity. Gains and losses on sales of securities are determined on the specific-identification method. Amortization of premiums and accretion of discounts are recorded as interest income from securities.

Available for sale and held to maturity securities are evaluated for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities are generally evaluated for OTTI under ASC 320. However, certain purchased beneficial interest, including certain non-agency government-sponsored mortgage-backed securities, asset-backed securities and collateralized debt obligations are evaluated using the model outlined in ASC 325-10.

In determining OTTI under ASC 320, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Corporation has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether a decline exists that is other-than-temporary, involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When the Corporation does not intend to sell a debt security, and it is more likely than not, the Corporation will not have to sell the security before recovery of its cost basis, it recognizes the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors has been recognized in other comprehensive income, net of applicable income taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

If the intent is to sell or it is more likely than not that the Corporation will be required to sell the security before recovery of its amortized cost basis, less any recognized credit loss, the OTTI is recognized in earnings equal to the entire difference between the investment’s amortized cost basis, less any recognized credit loss, and its fair value at the balance sheet date.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

HELD TO MATURITY SECURITIES are classified as held to maturity when the Corporation has the positive intent and ability to hold the securities to maturity. Securities held to maturity are carried at amortized cost. For held to maturity debt securities, the amount of an OTTI recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

LOANS HELD FOR SALE are carried at the principal amount outstanding. The carrying amount approximates fair value due to the short duration between origination and the date of sale.

LOANS held in the Corporation's portfolio are carried at the principal amount outstanding, net of unearned income. Certain non-accrual and substantially delinquent loans may be considered to be impaired. A loan is impaired when, based on current information or events, it is probable that the Bank will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. In applying the provisions of ASC 310, the Corporation considers its investment in one-to-four family residential loans and consumer installment loans to be homogeneous and therefore excluded from separate identification for evaluation of impairment. Interest income is accrued on the principal balances of loans, except for installment loans with add-on interest, for which a method that approximates the level yield method is used. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed against earnings when considered uncollectable. Interest income accrued in the prior year, if any, is charged to the allowance for loan losses. Interest income is subsequently recognized only to the extent cash payments are received and the loan is returned to accruing status. Certain loan fees and direct costs are being deferred and amortized as an adjustment of yield on the loans.

Impaired loans are carried at the present value of estimated future cash flows using the loan's existing rate, or the fair value of collateral if the loan is collateral dependent. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of the loan is confirmed. The valuation would be considered Level 3, consisting of appraisals of underlying collateral and discounted cash flow analysis.

Loan commitments and letters-of-credit generally have short-term, variable-rate features and contain clauses which limit the Bank's exposure to changes in customer credit quality. Accordingly, their carrying values, which are immaterial at the respective balance sheet dates, are reasonable estimates of fair value.

LOANS ACQUIRED IN BUSINESS COMBINATIONS with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered to be credit impaired. Evidence of credit quality deterioration as of purchase dates may include information such as past-due and nonaccrual status, borrower credit scores and recent loan to value percentages. Acquired credit-impaired loans are accounted for under the accounting guidance for loans and debt securities acquired with deteriorated credit quality (ASC 310-30). These loans are initially measured at fair value based upon expected cash flows without anticipation of prepayments and includes estimated future credit losses expected to be incurred over the life of the loans. As a result, related discounts are recognized subsequently through accretion based on the expected cash flows of the acquired loans. For purposes of applying ASC 310-30, loans acquired in business combinations are aggregated into pools of



loans with common risk characteristics for the initial fair value measurement. Accordingly, allowances for credit losses related to these loans are not carried over and recorded at the acquisition date.

The expected cash flows of the acquired loans in excess of the fair values recorded is referred to as the accretable yield and is recognized in interest income over the remaining estimated lives of the loans. The Corporation will continually evaluate the fair value of the loans including cash flows expected to be collected.

ALLOWANCE FOR LOAN LOSSES is maintained to absorb losses inherent in the loan portfolio and is based on ongoing, quarterly assessments of the probable losses inherent in the loan portfolio. The allowance is increased by the provision for loan losses, which is charged against current operating results. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The Corporation's strategy for credit risk management includes conservative credit policies and underwriting criteria for all loans, as well as an overall credit limit for each customer significantly below legal lending limits. The strategy also emphasizes diversification on a regional geographic, industry and customer level, regular credit quality reviews and management reviews of large credit exposures and loans experiencing deterioration of credit quality.

The Corporation's methodology for assessing the appropriateness of the allowance consists of three key elements – the determination of the appropriate reserves for specifically identified loans, probable losses estimated from historical loss rates, and probable losses resulting from economic, environmental, qualitative or other deterioration above and beyond what is reflected in the first two components of the allowance.

Larger commercial loans that exhibit probable or observed credit weaknesses are subject to individual review. Where appropriate, reserves are allocated to individual loans based on management's estimate of the borrower's ability to repay the loan given the availability of collateral, other sources of cash flow and legal options available to the Corporation. Included in the review of individual loans are those that are impaired as provided in ASC 310. Any allowances for impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or fair value of the underlying collateral. The Corporation evaluates the collectability of both principal and interest when assessing the need for a loss accrual. Historical loss rates are applied to other commercial loans not subject to specific reserve allocations.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The historical allocation for commercial loans graded pass are established by loan segments using loss rates based on the Corporation's migration analysis. This migration analysis shows the loss rates for each segment of loans based on the loan grades at the beginning of the twelve month period. This loss rate is then applied to the current portfolio of loans in each respective loan segment.

Homogenous loans, such as consumer installment and residential mortgage loans, are not individually risk graded. Reserves are established for each segment of loans using loss rates based on charge offs for the same period as the migration analysis used for commercial loans.

Historical loss allocations for commercial and consumer loans may be adjusted for significant factors that, in management's judgment, reflect the impact of any current conditions on loss recognition. Factors which management considers in the analysis include the effects of the national and local economies, trends in loan growth and charge-off rates, changes in mix, concentration of loans in specific industries, asset quality trends (delinquencies, charge offs and non-accrual loans), risk management and loan administration, changes in the internal lending policies and credit standards, examination results from bank regulatory agencies and the Corporation's internal loan review.

PENSION benefits are provided to the Corporation's employees. Its accounting policies related to pensions and other post retirement benefits reflect the guidance in ASC 715, Compensation – Retirement Benefits. The Corporation does not consolidate the assets and liabilities associated with the pension plan. Instead, the Corporation recognizes the funded status of the plan in the consolidated balance sheets. The measurement of the funded status and the annual pension expense involves actuarial and economic assumptions. Various statistical and other factors, which attempt to anticipate future events, are used in calculating the expense and liabilities related to the plans. Key factors include assumptions on the expected rates of return on plan assets, discount rates, expected rates of salary increases and health care costs and trends. The Corporation considers market conditions, including changes in investment returns and interest rates in making these assumptions. The primary assumptions used in determining the Corporation's pension and post retirement benefit obligations and related expenses are presented in Note 21. PENSION AND OTHER POST RETIREMENT BENEFIT PLANS, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

PREMISES AND EQUIPMENT is carried at cost net of accumulated depreciation. Depreciation is computed using the straight-line and declining balance methods based on the estimated useful lives of the assets ranging from three to forty years. Maintenance and repairs are expensed as incurred, while major additions and improvements, which extend the useful life, are capitalized. Gains and losses on dispositions are included in current operations.

FEDERAL RESERVE AND FEDERAL HOME LOAN BANK STOCK are required investments for institutions that are members of the Federal Reserve Bank ("FRB") and Federal Home Loan Bank systems. The required investment in the common stock is based on a predetermined formula based on the level of borrowings and other factors. These investments are carried at cost, classified as a restricted security and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

INTANGIBLE ASSETS that are subject to amortization, including core deposit intangibles, are being amortized on both the straight-line and accelerated basis over three to twenty years. Intangible assets are periodically evaluated as to the recoverability of their carrying value.

GOODWILL is maintained by applying the provisions of ASC 350. For purchase acquisitions, the Corporation is required to record the assets acquired, including identified intangible assets, and the liabilities assumed at their fair value, which in many instances involves estimates based on third party valuations, such as appraisals, or internal valuations based on discounted cash flow analysis or other valuation techniques that may include estimates of attrition, inflation, asset growth rates or other relevant factors. In addition, the determination of the useful lives for which an intangible asset will be amortized is subjective.

Under ASC 350, Intangibles – Goodwill and Other, the Corporation is required to evaluate goodwill for impairment on an annual basis, as well as on an interim basis, if events or changes indicate that the asset may be impaired, indicating that the carrying value may not be recoverable. The Corporation has historically elected to test for goodwill impairment as of October 1 of each year and has determined that no impairment exists.

BANK OWNED LIFE INSURANCE has been purchased on certain employees and directors of the Corporation. The Corporation records the life insurance at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or amounts due that are probable at settlement.

OTHER REAL ESTATE OWNED consists of assets acquired through, or in lieu of, loan foreclosure and are held for sale. They are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation are included in net income or expense from foreclosed assets. Other real estate owned also includes bank premises qualifying as held for sale. Bank premises are transferred at the lower of carrying value or fair value less cost to sell.

DERIVATIVE INSTRUMENTS are carried at the fair value of the derivatives and reflects the estimated amounts that would have been received to terminate these contracts at the reporting date based upon pricing or valuation models applied to current market information.

As part of the asset/liability management program, the Corporation will utilize, from time to time, interest rate floors, caps or swaps to reduce its sensitivity to interest rate fluctuations. These are derivative instruments, which are recorded as assets or liabilities in the consolidated balance sheets at fair value. Changes in the fair values of derivatives are reported in the consolidated statements of operations or other comprehensive income (“OCI”) depending on the use of the derivative and whether the instrument qualifies for hedge accounting. The key criterion for the hedge accounting is that the hedged relationship must be highly effective in achieving offsetting changes in those cash flows that are attributable to the hedged risk, both at inception of the hedge and on an ongoing basis.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Derivatives that qualify for the hedge accounting treatment are designated as either: a hedge of the fair value of the recognized asset or liability or of an unrecognized firm commitment (a fair value hedge) or a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability (a cash flow hedge). To date, the Corporation has only entered into a cash flow hedge. For cash flow hedges, changes in the fair values of the derivative instruments are reported in OCI to the extent the hedge is effective. The gains and losses on derivative instruments that are reported in OCI are reflected in the consolidated statements of income in the periods in which the results of operations are impacted by the variability of the cash flows of the hedged item. Generally, net interest income is increased or decreased by amounts receivable or payable with respect to the derivatives, which qualify for hedge accounting. At inception of the hedge, the Corporation establishes the method it uses for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. The ineffective portion of the hedge, if any, is recognized currently in the consolidated statements of operations. The Corporation excludes the time value expiration of the hedge when measuring ineffectiveness.

The Corporation offers interest rate derivative products (e.g. interest rate swaps) to certain of its high-quality commercial borrowers. This product allows customers to enter into an agreement with the Corporation to swap their variable rate loan to a fixed rate. These derivative products are designed to reduce, eliminate or modify the risk of changes in the borrower's interest rate or market price risk. The extension of credit incurred through the execution of these derivative products is subject to the same approvals and rigorous underwriting standards as the related traditional credit product. The Corporation limits its risk exposure to these products by entering into a mirror-image, offsetting swap agreement with a separate, well-capitalized and rated counterparty previously approved by the Credit and Asset Liability Committee. By using these interest rate swap arrangements, the Corporation is also better insulated from the interest rate risk associated with underwriting fixed-rate loans. These derivative contracts are not designated against specific assets or liabilities under ASC 815, Derivatives and Hedging, and, therefore, do not qualify for hedge accounting. The derivatives are recorded on the balance sheet at fair value and changes in fair value of both the customer and the offsetting swap agreements are recorded (and essentially offset) in non-interest income. The fair value of the derivative instruments incorporates a consideration of credit risk (in accordance with ASC 820), resulting in some volatility in earnings each period.

INCOME TAX in the consolidated statements of income includes deferred income tax provisions or benefits for all significant temporary differences in recognizing income and expenses for financial reporting and income tax purposes. The Corporation files consolidated income tax returns with its subsidiaries.

The Corporation adopted the provisions of the ASC 740, Income Taxes, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As a result of the implementation of ASC 740, the Corporation did not identify any uncertain tax positions that it believes should be recognized in the financial statements. The tax years still subject to examination by taxing authorities are years subsequent to 2010.

STOCK OPTION AND RESTRICTED STOCK AWARD PLANS are maintained by the Corporation. The compensation costs are recognized for stock options and restricted stock awards issued to employees and directors based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options. The market price of the Corporation's common stock at the date of grant is used for restricted stock awards. Compensation expense is recognized over the appropriate service period, which is generally two or

three years.

TRANSFERS OF FINANCIAL ASSETS are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation and put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

NET INCOME PER SHARE is computed by dividing net income available to common shareholders by the weighted-average number of shares of common stock outstanding. Diluted net income per share is computed by dividing net income available to common shareholders by the weighted-average number of shares of common stock outstanding, plus the dilutive effect of outstanding stock options and nonvested restricted stock.

RECLASSIFICATIONS have been made to prior financial statements to conform to the current financial statement presentation. These reclassifications had no effect on net income.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 2

## PURCHASE AND ASSUMPTION

Effective February 10, 2012, the Bank assumed substantially all of the deposits and certain other liabilities and acquired certain assets of SCB Bank, a federal savings bank headquartered in Shelbyville, Indiana, from the Federal Deposit Insurance Corporation (“FDIC”), as receiver for SCB Bank (the “Acquisition”), pursuant to the terms of the Purchase and Assumption Agreement - Modified Whole Bank; All Deposits (the “Agreement”), entered into by the Bank, the FDIC as receiver of SCB Bank and the FDIC.

Under the terms of the Agreement, the Bank acquired \$147.7 million in assets, including approximately \$11.9 million of cash and cash equivalents, \$18.9 million of marketable securities, \$1.8 million in Federal Home Loan Bank stock, \$113.0 million in loans and \$2.1 million of premises and other assets. The Bank assumed approximately \$135.7 million of liabilities, including approximately \$125.9 million in customer deposits, \$9.6 million of other borrowed money and \$402,000 in other liabilities. These balances are book balances and do not reflect the fair value adjustments which are shown in the following table. The acquisition did not include any loss sharing agreement with the FDIC.

The bid accepted by the FDIC included no deposit premium. The assets were acquired at a discount of \$29.0 million from book value. The FDIC made a payment of \$17.2 million to the Bank upon the final closing date balance sheet for SCB Bank that reflected the difference between the purchase price of the assets acquired and the value of the liabilities assumed.

The Bank engaged in this transaction with the expectation that it would be immediately accretive and add a new market area with a demographic profile consistent with many of the current Indiana markets served by the Bank.

The transaction was accounted for under the acquisition method of accounting in accordance with the Business Combination topic of the FASB Accounting Standards Codification (“ASC 310-20 and 310-30”). The statement of net assets and liabilities acquired as of February 10, 2012, are presented below. The assets and liabilities of SCB Bank were recorded at the respective acquisition date provisional fair values, and identifiable intangible assets were recorded at provisional fair value.

Assets		Liabilities	
Cash and due from banks <sup>(1)</sup>	\$29,113	Deposits:	
Investment securities, available for sale	18,896	Non-interest bearing	\$13,715
Federal Home Loan Bank stock	1,761	NOW accounts	14,746
Loans:		Savings and money market	25,843
Commercial	51,042	Certificate of deposit	71,605
Residential mortgage	11,181	Total Deposits	125,909
Installment	31,570		
Total Loans	93,793	Federal Home Loan Bank advances	10,286
		Other liabilities	804
Premises	1,516	Total Liabilities Assumed	\$136,999
Core deposit intangible	484		

Other assets	560	Net Gain on Acquisition	\$9,124
Total Assets Purchased	\$146,123		

(1) Includes \$17,200,000 cash received from the FDIC.

In many cases, the fair values of assets acquired and liabilities assumed were determined by estimating cash flows expected to result from those assets and liabilities and discounting them at appropriate market rates. The most significant category of assets for which this procedure was used was acquired loans. The Bank acquired the \$113.0 million loan portfolio at a fair value discount of \$19.2 million. The performing portion of the portfolio, \$86.3 million, had an estimated fair value of \$76.5 million. The excess of expected cash flows above the fair value of the performing portion of loans will be accreted to interest income over the remaining lives of the loans in accordance with ASC 310-20. Discounts or premiums on term loans are accounted for under an effective yield method. Prepayments on term loans would be accounted for in the effective yield calculation. Discounts or premiums on lines of credit are treated in a straight line method over the term of the lines of credit.

Certain loans for which specific credit-related deterioration has occurred since origination are recorded at fair value which is derived from calculating the present value of the amounts expected to be collected. Income recognition on these loans is based on reasonable expectation about the timing and amount of cash flows to be collected. Some of the acquired loans deemed impaired and considered collateral dependent, with the timing of a sale of loan collateral indeterminate, remain on non-accrual status and have little or no accretable yield.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

In accordance with ASC 310-30 (formerly Statement of Position (“SOP”) 03-3 as of February 10, 2012, loans acquired during 2012 for which it was probable at acquisition that all contractually required payments would not be collected are as follows:

Preliminary estimate of contractually required principal and interest at acquisition	\$31,143
Preliminary estimate of contractual cash flows not expected to be collected (nonaccretable differences)	9,688
Preliminary estimate of expected cash flows at acquisition	21,455
Preliminary estimate of interest component of expected cash flows (accretable discount)	4,152
Preliminary estimate of fair value of acquired loans accounted for under ASC 310-30	\$17,303

Pro-forma statements were determined to be impracticable due to the nature of the transaction as certain assets were not purchased.

## NOTE 3

## BUSINESS COMBINATIONS

## Community Bancshares, Inc.

On November 7, 2014, the Corporation acquired 100 percent of Community Bancshares, Inc. ("Community"). Community was headquartered in Noblesville, Indiana and had 10 full-service banking centers serving central Indiana. Pursuant to the merger agreement, each outstanding share of common stock of Community was converted into the right to receive either (a) 4.0926 shares of the Corporation's common stock, plus cash in lieu of fractional shares; or (b) \$85.94 in cash, based upon shareholder elections. The Corporation paid \$14.2 million in cash and issued approximately 1.6 million shares of common stock, valued at approximately \$35.0 million, for a total purchase price of approximately \$49.2 million.

The Corporation engaged in this transaction with the expectation that it would be accretive and expand the existing footprint in central Indiana. Goodwill resulted from this transaction due to the expected synergies from combining operations.

Under the acquisition method of accounting, the total purchase price is allocated to net tangible and intangible assets based on their current estimated fair values on the date of the acquisition. Based on preliminary valuations of the fair value of tangible and intangible assets acquired and liabilities assumed, which are based on assumptions that are subject to change, the purchase price for the Community acquisition is detailed in the following table.

Prior to the end of the one year measurement period for finalizing the purchase price allocation, if information becomes available which would indicate adjustments are required to the purchase price allocation, such adjustments will be included in the purchase price allocation retrospectively.

	Fair Value
Cash and cash equivalents	\$4,124
Interest -bearing time deposits	16,526
Investment Securities, available for sale	76,807



Loans	145,064	
Premises and equipment	3,610	
Federal Home Loan Bank stock	1,950	
Interest Receivable	767	
Cash surrender value of life insurance	3,266	
Other real estate owned	6,662	
Taxes, deferred and receivable	3,348	
Other assets	167	
Deposits	(228,424	)
Interest payable	(98	)
Other liabilities	(3,014	)
Net tangible assets acquired	\$30,755	
Core deposit intangible	4,658	
Goodwill	13,776	
Purchase price	\$49,189	

Of the total purchase price, \$4,658,000 has been allocated to a core deposit intangible that will be amortized over its estimated life of 10 years. The remaining purchase price has been allocated to goodwill, which is not deductible for tax purposes.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CFS Bancorp, Inc.

On November 12, 2013, the Corporation acquired 100 percent of CFS Bancorp, Inc. ("CFS") in an all stock transaction. CFS was headquartered in Munster, Indiana and had 20 full-service banking centers serving the northwestern Indiana and northeastern Illinois areas. Pursuant to the merger agreement, the shareholders of CFS received 0.65 percent of a share of the Corporation's common stock for each share of CFS Bancorp common stock held. The Corporation issued approximately 7.1 million shares of common stock, which was valued at approximately \$135.6 million.

The Corporation engaged in this transaction with the expectation that it would be accretive and add a new market area with a demographic profile consistent with many of the current Indiana markets served by the Bank. Goodwill resulted from this transaction due to the expected synergies from combining operations.

The purchase price for the CFS acquisition was allocated as follows:

	Fair Value	
Cash and cash equivalents	\$ 10,992	
Interest-bearing time deposits	213,379	
Investment securities available for sale	15,913	
Investment securities held to maturity	14,372	
Mortgage loans held for sale	189	
Loans	603,114	
Premises and equipment	19,643	
Federal Home Loan Bank stock	6,188	
Interest receivable	1,770	
Cash surrender value of life insurance	36,555	
Other real estate owned	12,857	
Tax asset, deferred and receivable	30,717	
Other assets	111,656	
Deposits	(955,432	)
Securities sold under repurchase agreements	(9,830	)
Federal Home Loan Bank advances	(15,000	)
Interest payable	(294	)
Other liabilities	(16,033	)
Net tangible assets acquired	\$80,756	
Core deposit intangible	7,313	
Goodwill	47,573	
Purchase price	\$ 135,642	

Of the total purchase price, \$7,313,000 has been allocated to a core deposit intangible that will be amortized over its estimated life of 10 years. The remaining purchase price has been allocated to goodwill, which is not deductible for tax purposes.

## Pro Forma Financial Information

The results of operations of Community and CFS have been included in the Corporation's consolidated financial statements since the acquisition dates. The following schedule includes pro forma results for the periods ended December 31, 2014, 2013 and 2012 as if the Community and CFS acquisitions had occurred as of the beginning of the comparable prior annual reporting period.

	2014	2013	2012
Total revenue (net interest income plus other income)	\$263,070	\$253,668	\$266,034
Net income	\$61,572	\$39,979	\$50,092
Net income available to common shareholders	\$61,572	\$37,599	\$45,553
Earnings per share:			
Basic	\$1.63	\$0.98	\$1.28
Diluted	\$1.61	\$0.97	\$1.27

The pro forma information includes adjustments for interest income on loans, amortization of intangibles arising from the transaction, interest expense on deposits acquired, premises expense for the banking centers acquired and the related income tax effects. The pro forma information for the year ended 2014 includes \$1.6 million of operating revenue from Community since the acquisition and approximately \$1.8 million, net of tax, of non-recurring expenses directly attributable to the Community acquisition. The pro forma information for the year ended 2013 includes \$4.9 million of operating revenue from CFS since the acquisition and approximately \$9.5 million, net of tax, of non-recurring expenses directly attributable to the CFS acquisition.

The pro forma financial information is presented for information purposes only and is not indicative of the results of operations that actually would have been achieved had the acquisition consummated as of that time, nor is it intended to be a projection of future results.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 4

## RESTRICTION ON CASH AND DUE FROM BANKS

The Corporation considers all liquid investments with original maturities of three months or less to be cash equivalents. As of December 31, 2014, cash and cash equivalents is defined to include cash on hand, deposits in other institutions and federal funds sold.

Effective October 3, 2008, the FDIC's insurance limits temporarily increased to \$250,000. On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") was signed into law, which, in part, permanently raised the standard maximum deposit insurance amount to \$250,000. On November 9, 2010, the FDIC implemented section 343 of the Dodd-Frank Act providing unlimited insurance coverage on noninterest-bearing transaction accounts. Beginning December 31, 2010, through December 31, 2012, all noninterest-bearing transaction accounts were fully insured, regardless of the balance of the account, at all FDIC-insured institutions. As of January 1, 2013, noninterest-bearing transaction deposit accounts are no longer insured separately from other accounts at the same FDIC-insured institution. Instead, noninterest-bearing transaction accounts are added to any of the Corporation's other accounts, and the aggregate balance insured up to at least the Standard Maximum Deposit Insurance Amount of \$250,000, at each institution.

At December 31, 2014, the Corporation's interest-bearing cash accounts and noninterest-bearing transaction deposits held at other institutions exceeded federally insured limits by approximately \$103,154,000. Each correspondent bank's financial performance and market rating are reviewed on a quarterly basis to ensure the Corporation has deposits only at institutions providing minimal risk for those exceeding the federally insured limits.

Additionally, the Corporation had approximately \$13,910,000 at the Federal Home Loan Bank and Federal Reserve Bank, which are government-sponsored entities not insured by the FDIC.

The Corporation is required to maintain reserve funds in cash and/or on deposit with the Federal Reserve Bank. The reserve required at December 31, 2014, was \$22,595,000.

## NOTE 5

## INVESTMENT SECURITIES

The amortized cost, gross unrealized gains, gross unrealized losses and approximate market value of the Corporation's investment securities at the dates indicated were:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2014				
U.S. Government-sponsored agency securities	\$ 100	\$ 9		\$ 109
State and municipal	216,915	11,801	\$ 123	228,593

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

U.S. Government-sponsored mortgage-backed securities	310,460	8,771	127	319,104
Corporate obligations	31			31
Equity securities	1,706			1,706
Total available for sale	529,212	20,581	250	549,543
Held to maturity at December 31, 2014				
State and municipal	204,443	5,716	96	210,063
U.S. Government-sponsored mortgage-backed securities	426,645	11,527	512	437,660
Total held to maturity	631,088	17,243	608	647,723
Total Investment Securities	\$1,160,300	\$37,824	\$858	\$1,197,266
Available for sale at December 31, 2013				
U.S. Treasury	\$15,914	\$80	\$21	\$15,973
U.S. Government-sponsored agency securities	3,550	12	17	3,545
State and municipal	231,005	3,878	3,896	230,987
U.S. Government-sponsored mortgage-backed securities	279,299	3,926	1,973	281,252
Corporate obligations	6,374		3,636	2,738
Equity securities	1,706			1,706
Total available for sale	537,848	7,896	9,543	536,201
Held to maturity at December 31, 2013				
State and municipal	145,941	62	91	145,912
U.S. Government-sponsored mortgage-backed securities	413,437	5,220	3,722	414,935
Total held to maturity	559,378	5,282	3,813	560,847
Total Investment Securities	\$1,097,226	\$13,178	\$13,356	\$1,097,048

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Certain investments in debt securities are reported in the financial statements at amounts less than their historical cost. The historical cost of these investments totaled \$73,249,000 and \$490,488,000 at December 31, 2014 and 2013, respectively. Total fair value of these investments was \$72,390,000 and \$477,132,000, which was approximately 6.1 and 43.6 percent of the Corporation's available for sale and held to maturity investment portfolio at December 31, 2014 and 2013, respectively.

Except as discussed below, management believes the decline in fair value for these securities was temporary. Should the impairment of any of these securities become other-than-temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income during the period the other-than-temporary impairment ("OTTI") is identified.

The Corporation's management has evaluated all securities with unrealized losses for OTTI as of December 31, 2014. The evaluations are based on the nature of the securities, the extent and duration of the loss and the intent and ability of the Corporation to hold these securities either to maturity or through the expected recovery period.

In determining the fair value of the investment securities portfolio, the Corporation utilizes a third party for portfolio accounting services, including market value input, for those securities classified as Level I and Level II in the fair value hierarchy. The Corporation has obtained an understanding of what inputs are being used by the vendor in pricing the portfolio and how the vendor classified these securities based upon these inputs. From these discussions, the Corporation's management is comfortable that the classifications are proper. The Corporation has gained trust in the data for two reasons: (a) independent spot testing of the data is conducted by the Corporation through obtaining market quotes from various brokers on a periodic basis; and (b) actual gains or loss resulting from the sale of certain securities has proven the data to be accurate over time. Fair value of securities classified as Level 3 in the valuation hierarchy was determined using a discounted cash flow model that incorporated market estimates of interest rates and volatility in markets that have not been active.

#### U.S. Government-Sponsored Mortgage-Backed Securities

The unrealized losses on the Corporation's investment in mortgage-backed securities were a result of interest rate changes. The Corporation expects to recover the amortized cost basis over the term of the securities. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Corporation does not intend to sell the investments and it is not more likely than not that the Corporation will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Corporation does not consider those investments to be other-than-temporarily impaired at December 31, 2014. As noted in the table above, the mortgage-backed securities portfolio contains unrealized losses of \$127,000 on four securities and \$512,000 on thirteen securities in the available for sale and held to maturity portfolios, respectively. All these securities are issued by a government-sponsored entity.

#### State and Municipal Securities

The unrealized losses on the Corporation's investments in securities of state and political subdivisions were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Corporation does not intend to sell the investments and it is not more likely than not that the Corporation will be required to sell the investments before

recovery of their amortized cost basis, which may be maturity, the Corporation does not consider those investments to be other-than-temporarily impaired at December 31, 2014. As noted in the table above, the state and political subdivision securities portfolio contains unrealized losses of \$123,000 on twenty-two securities and \$96,000 on sixteen securities in the available for sale and held to maturity portfolios respectively.

#### Corporate Obligations

In 2013, the Corporation's unrealized losses on trust preferred securities totaled \$3.6 million on a book value of \$6.4 million. In 2014, the Corporation sold all but one of its trust preferred securities, which resulted in gains of \$1.9 million. These securities had previous OTTI of \$9.4 million. The one remaining trust preferred security has no remaining book value as a result of OTTI of approximately \$500,000 taken in 2009.

#### Certain Losses Recognized on Investments

Certain debt securities have experienced fair value deterioration due to credit losses and other market factors. The following table provides information about debt securities for which only a credit loss was recognized in income and other losses were recorded in other comprehensive income.

	Accumulated Credit Losses in 2014	Accumulated Credit Losses in 2013
Credit losses on debt securities held:		
Balance, January 1	\$ 11,355	\$ 11,355
Reductions for previous other-than-temporary losses realized on securities sold during the year	(10,855 )	
Balance, December 31	\$ 500	\$ 11,355

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The following table shows the Corporation's gross unrealized losses and fair value, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position at December 31, 2014 and 2013:

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Available for Sale Securities at December 31, 2014						
State and municipal	\$1,256	\$7	\$9,850	\$116	\$11,106	\$123
U.S. Government-sponsored mortgage-backed securities	2,186	13	5,447	114	7,633	127
Total Temporarily Impaired Available for Sale Securities	3,442	20	15,297	230	18,739	250
Temporarily Impaired Held to Maturity Securities at December 31, 2014						
State and municipal	5,119	96	250		5,369	96
U.S. Government-sponsored mortgage-backed securities	9,791	82	38,491	430	48,282	512
Total Temporarily Impaired Held to Maturity Securities	14,910	178	38,741	430	53,651	608
Total Temporarily Impaired Investment Securities	\$18,352	\$198	\$54,038	\$660	\$72,390	\$858
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Available for Sale Securities at December 31, 2013						
U.S. Treasury	\$4,875	\$21			\$4,875	\$21
U.S. Government-sponsored agency securities	3,433	17			3,433	17
State and municipal	111,791	3,840	\$583	\$56	112,374	3,896
U.S. Government-sponsored mortgage-backed securities	117,866	1,701	2,683	272	120,549	1,973
Corporate obligations			2,711	3,636	2,711	3,636
Total Temporarily Impaired Available for Sale Securities	237,965	5,579	5,977	3,964	243,942	9,543
Temporarily Impaired Held to Maturity Securities at December 31, 2013						
State and municipal	17,318	91	184		17,502	91



Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

U.S. Government-sponsored mortgage-backed securities	213,048	3,462	2,640	260	215,688	3,722
Total Temporarily Impaired Held to Maturity Securities	230,366	3,553	2,824	260	233,190	3,813
Total Temporarily Impaired Investment Securities	\$468,331	\$9,132	\$8,801	\$4,224	\$477,132	\$13,356

The amortized cost and fair value of securities available for sale and held to maturity at December 31, 2014 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Maturity Distribution at December 31, 2014				
Due in one year or less	\$3,127	\$3,153	\$6,258	\$6,329
Due after one through five years	9,565	9,840	18,440	18,930
Due after five through ten years	48,675	50,889	85,997	87,903
Due after ten years	155,679	164,851	93,748	96,901
	217,046	228,733	204,443	210,063
U.S. Government-sponsored mortgage-backed securities	310,460	319,104	426,645	437,660
Equity securities	1,706	1,706		
Total Investment Securities	\$529,212	\$549,543	\$631,088	\$647,723

Securities with a carrying value of approximately \$449,408,000, \$373,533,000 and \$345,866,000 were pledged at December 31, 2014, 2013 and 2012, respectively, to secure certain deposits and securities sold under repurchase agreements, and for other purposes as permitted or required by law.

Gross gains of \$3,581,000, \$487,000 and \$2,389,000 were realized on sales of available for sale securities in 2014, 2013 and 2012, respectively. There were no losses from the sale of available for sale securities in 2014, 2013 or 2012, respectively.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 6

## LOANS AND ALLOWANCE

The Corporation's primary lending focus is small business and middle market commercial, commercial real estate, residential real estate and consumer, which results in portfolio diversification. The following tables show the composition of the loan portfolio, the allowance for loan losses and certain credit quality elements, all excluding loans held for sale. Loans held for sale at December 31, 2014 and 2013, were \$7,235,000 and \$5,331,000, respectively.

The following table illustrates the composition of the Corporation's loan portfolio by loan class for the years indicated:

	December 31, 2014	December 31, 2013
Commercial and industrial loans	\$896,688	\$761,705
Agricultural production financing and other loans to farmers	104,927	114,348
Real estate loans:		
Construction	207,221	177,082
Commercial and farmland	1,672,661	1,611,809
Residential	647,315	616,385
Home equity	286,529	255,223
Individuals' loans for household and other personal expenditures	73,400	69,783
Lease financing receivables, net of unearned income	1,106	1,545
Other loans	35,018	24,529
Loans	3,924,865	3,632,409
Allowance for loan losses	(63,964 )	(67,870 )
Net Loans	\$3,860,901	\$3,564,539

## Allowance, Credit Quality and Loan Portfolio

The Corporation maintains an allowance for loan losses to cover probable credit losses identified during its loan review process. Management believes that the allowance for loan losses is adequate to cover probable losses inherent in the loan portfolio at December 31, 2014. The process for determining the adequacy of the allowance for loan losses is critical to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments to estimate the effect of uncertain matters. The allowance for loan losses considers current factors, including economic conditions and ongoing internal and external examinations, and will increase or decrease as deemed necessary to ensure the allowance remains adequate. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, loan mix and collateral values.

The allowance is increased by the provision for loan losses and decreased by charge offs less recoveries. All charge offs are approved by the Bank's senior loan officers or loan committees, depending on the amount of the charge off. The Bank charges off a loan when a determination is made that all or a portion of the loan is uncollectible. The

allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The amount provided for loan losses in a given period may be greater than or less than net loan losses experienced during the period, and is based on management's judgment as to the appropriate level of the allowance for loan losses. The determination of the provision amount in a given period is based on management's ongoing review and evaluation of the loan portfolio, including an internally administered loan "watch" list and independent loan reviews. The evaluation takes into consideration identified credit problems, the possibility of losses inherent in the loan portfolio that are not specifically identified and management's judgment as to the impact of the current environment and economic conditions on the portfolio.

In conformance with ASC 805 and ASC 820, loans purchased after December 31, 2008 are recorded at the acquisition date fair value. Such loans are only included in the allowance to the extent a specific impairment is identified that exceeds the fair value adjustment on an impaired loan or the historical loss and environmental factor analysis indicates losses inherent in a purchased portfolio exceeds the fair value adjustment on the portion of the purchased portfolio not deemed impaired.

The allowance consists of specific impairment reserves as required by ASC 310-10-35, a component for historical losses in accordance with ASC 450 and the consideration of current environmental factors in accordance with ASC 450. A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The historical loss allocation for loans not deemed impaired according to ASC 310 is the product of the volume of loans within the non-impaired criticized and non-criticized risk grade classifications, each segmented by call code, and the historical loss factor for each respective classification and call code segment. The historical loss factors are based upon actual loss experience within each risk and call code classification. The historical look back period for non-criticized loans looks to the most recent rolling-four-quarter average and aligns with the look back period for non-impaired criticized loans. Each of the rolling four quarter periods used to obtain the average, include all charge offs for the previous twelve-month period, therefore the historical look back period includes seven quarters. The resulting allocation is reflective of current conditions. Criticized loans are grouped based on the risk grade assigned to the loan. Loans with a special mention grade are assigned a loss factor, and loans with a classified grade but not impaired are assigned a separate loss factor. The loss factor computation for this allocation includes a segmented historical loss migration analysis of criticized risk grades to charge off.

In addition to the specific reserves and historical loss components of the allowance, consideration is given to various environmental factors to help ensure that losses inherent in the portfolio are reflected in the allowance for loan losses. The environmental component adjusts the historical loss allocations for commercial and consumer loans to reflect relevant current conditions that, in management's opinion, have an impact on loss recognition. Environmental factors that management reviews in the analysis include: national and local economic trends and conditions; trends in growth in the loan portfolio and growth in higher risk areas; levels of, and trends in, delinquencies and non-accruals; experience and depth of lending management and staff; adequacy of, and adherence to, lending policies and procedures including those for underwriting; industry concentrations of credit; and adequacy of risk identification systems and controls through the internal loan review and internal audit processes.

At December 31, 2014, the allowance for loan losses was \$63,964,000, a decrease of \$3,906,000 from the December 31, 2013 balance of \$67,870,000. Specific reserves on impaired loans increased \$1,186,000 to \$2,769,000, from \$1,583,000 at December 31, 2013. Net charge offs for the twelve months ended December 31, 2014, were \$6,466,000, a decrease of \$1,678,000 from the same period in 2013. The provision for loan losses for the twelve months ended December 31, 2014 was \$2,560,000, a decrease of \$4,088,000 for the same period in in 2013. The determination of the provision for loan losses in any period is based on management's continuing review and evaluation of the loan portfolio, and its judgment as to the impact of current economic conditions on the portfolio.

The following table summarizes changes in the allowance for loan losses by loan segment for the twelve months ended December 31, 2014, 2013 and 2012:

	Twelve Months Ended December 31, 2014					Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	
Allowance for loan losses:						
Balances, January 1	\$27,176	\$23,102	\$2,515	\$15,077		\$67,870
Provision for losses	3,459	(464)	423	(839)	\$(19)	2,560
Recoveries on loans	5,435	3,297	377	1,783	24	10,916
Loans charged off	(7,246)	(6,608)	(657)	(2,869)	(2)	(17,382)
Balances, December 31, 2014	\$28,824	\$19,327	\$2,658	\$13,152	\$3	\$63,964

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

	Twelve Months Ended December 31, 2013					Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	
Allowance for loan losses:						
Balances, January 1	\$25,913	\$26,703	\$2,593	\$14,157		\$69,366
Provision for losses	2,794	340	(11	) 3,514	\$11	6,648
Recoveries on loans	4,586	3,552	556	1,292	4	9,990
Loans charged off	(6,117	) (7,493	) (623	) (3,886	) (15	) (18,134
Balances, December 31, 2013	\$27,176	\$23,102	\$2,515	\$15,077		\$67,870

	Twelve Months Ended December 31, 2012					Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	
Allowance for loan losses:						
Balances, January 1	\$17,731	\$37,919	\$2,902	\$12,343	\$3	\$70,898
Provision for losses	14,749	(2,546	) 126	6,176	29	18,534
Recoveries on loans	1,744	3,652	695	1,113	2	7,206
Loans charged off	(8,311	) (12,322	) (1,130	) (5,475	) (34	) (27,272
Balances, December 31, 2012	\$25,913	\$26,703	\$2,593	\$14,157		\$69,366

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The following tables show the Corporation's allowance for loan losses and loan portfolio by loan segment for the years indicated:

	December 31, 2014					Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	
Allowance balances:						
Individually evaluated for impairment	\$ 1,455	\$ 470		\$ 194		\$ 2,119
Collectively evaluated for impairment	27,369	18,207	\$ 2,658	12,958	\$ 3	61,195
Loans acquired with deteriorated credit quality		650				650
Total Allowance for Loan Losses	\$ 28,824	\$ 19,327	\$ 2,658	\$ 13,152	\$ 3	\$ 63,964
Loan balances:						
Individually evaluated for impairment	\$ 16,108	\$ 23,963		\$ 4,022		\$ 44,093
Collectively evaluated for impairment	1,011,122	1,796,797	\$ 73,400	925,282	\$ 1,106	3,807,707
Loans acquired with deteriorated credit quality	9,403	59,122		4,540		73,065
Loans	\$ 1,036,633	\$ 1,879,882	\$ 73,400	\$ 933,844	\$ 1,106	\$ 3,924,865

	December 31, 2013					Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	
Allowance balances:						
Individually evaluated for impairment	\$ 585	\$ 763		\$ 6		\$ 1,354
Collectively evaluated for impairment	26,493	22,208	\$ 2,515	15,071		66,287
Loans acquired with deteriorated credit quality	98	131				229
Total Allowance for Loan Losses	\$ 27,176	\$ 23,102	\$ 2,515	\$ 15,077		\$ 67,870
Loan balances:						
Individually evaluated for impairment	\$ 10,240	\$ 29,007		\$ 2,820		\$ 42,067
Collectively evaluated for impairment	882,794	1,690,285	\$ 69,783	867,094	\$ 1,545	3,511,501
Loans acquired with deteriorated credit quality	7,548	69,599		1,694		78,841
Loans	\$ 900,582	\$ 1,788,891	\$ 69,783	\$ 871,608	\$ 1,545	\$ 3,632,409

The risk characteristics of the Corporation's material portfolio segments are as follows:

**Commercial**

Commercial loans are primarily based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral

securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

#### Commercial real estate

These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral and risk grade criteria. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans.

#### Residential and Consumer

With respect to residential loans that are secured by 1-4 family residences and are typically owner occupied, the Corporation generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. Home equity loans are typically secured by a subordinate interest in 1-4 family residences, and consumer loans are secured by consumer assets such as automobiles or recreational vehicles. Some consumer loans are unsecured such as small installment loans and certain lines of credit. Repayment of these loans is primarily dependent on the personal income and credit rating of the borrowers, which can be impacted by economic conditions in their market areas such as unemployment levels. Repayment can also be impacted by changes in property values on residential properties. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Loans are reclassified to a non-accruing status when, in management's judgment, the collateral value and financial condition of the borrower do not justify accruing interest. Uncollected interest previously recorded, but not deemed collectible, is reversed and charged against current income. Payments subsequently received on non-accrual loans are applied to principal. A loan is returned to accrual status when principal and interest are no longer past due and collectability is probable, typically after a minimum of six consecutive months of performance. Payments received on impaired accruing or delinquent loans are applied to interest income as accrued.

The following table summarizes the Corporation's non-accrual loans by loan class for the years indicated:

	December 31, 2014	December 31, 2013
Commercial and industrial loans	\$7,048	\$9,283
Agriculture production financing and other loans to farmers	5,800	30
Real estate loans:		
Construction	1,439	4,978
Commercial and farmland	19,350	28,095
Residential	12,933	12,068
Home equity	1,988	1,667
Individuals' loans for household and other personal expenditures	231	117
Other loans		164
Total	\$48,789	\$56,402

Commercial impaired loans include non-accrual loans, loans accounted for under ASC 310-30, as well as substandard, doubtful and loss grade loans that were still accruing but deemed impaired according to the guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more and troubled debt restructurings.

Allowable methods for determining the amount of impairment include estimating fair value using the fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. The fair value of real estate is generally based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically ascertained by assessing, either singularly or some combination of, asset appraisals, accounts receivable aging reports, inventory listings and or customer financial statements. Both appraised values and values based on borrower's financial information are discounted as considered appropriate based on age and quality of the information and current market conditions.

The following tables show the composition of the Corporation's commercial impaired loans by loan class for the years indicated:

December 31, 2014



Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:					
Commercial and industrial loans	\$35,514	\$18,029		\$18,711	\$362
Agriculture production financing and other loans to farmers	26	22		26	
Real estate loans:					
Construction	12,956	9,318		9,837	427
Commercial and farmland	95,856	68,187		70,844	3,389
Residential	10,591	6,839		6,987	119
Home equity	3,590	398		402	
Other loans	30				
Total	\$158,563	\$102,793		\$106,807	\$4,297
Impaired loans with related allowance:					
Commercial and industrial loans	\$1,766	\$1,684	\$1,055	\$1,721	\$40
Agriculture production financing and other loans to farmers	6,777	5,777	400	8,044	1
Real estate loans:					
Commercial and farmland	7,159	4,971	1,120	4,999	24
Residential	1,001	998	194	1,000	
Total	\$16,703	\$13,430	\$2,769	\$15,764	\$65
Total Impaired Loans	\$175,266	\$116,223	\$2,769	\$122,571	\$4,362

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

	December 31, 2013				
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:					
Commercial and industrial loans	\$35,066	\$16,371		\$19,209	\$192
Agriculture production financing and other loans to farmers	32	30		32	
Real estate loans:					
Construction	16,109	10,625		11,621	117
Commercial and farmland	128,073	83,033		84,057	1,663
Residential	6,746	3,910		4,236	75
Home equity	3,299	112		225	
Other loans	454	172		181	1
Total	\$189,779	\$114,253		\$119,561	\$2,048
Impaired loans with related allowance:					
Commercial and industrial loans	\$1,390	\$1,216	\$683	\$1,240	\$9
Real estate loans:					
Construction					
Commercial and farmland	4,657	4,215	894	4,291	9
Residential	74	71	6	76	
Total	\$6,121	\$5,502	\$1,583	\$5,607	\$18
Total Impaired Loans	\$195,900	\$119,755	\$1,583	\$125,168	\$2,066
	December 31, 2012				
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:					
Commercial and industrial loans	\$28,532	\$11,730		\$15,089	\$124
Real estate loans:					
Construction	9,787	5,164		6,471	66
Commercial and farmland	58,173	43,204		46,788	1,211
Residential	8,820	6,215		7,129	83
Home equity	4,199	1,006		1,022	13
Other loans	83	14		18	1
Total	\$109,594	\$67,333		\$76,517	\$1,498
Impaired loans with related allowance:					
Commercial and industrial loans	\$4,415	\$4,155	\$1,628	\$4,225	\$33
Real estate loans:					
Construction	1,202	1,058	105	1,175	
Commercial and farmland	5,579	5,182	2,460	5,239	95
Residential	1,722	1,451	50	1,458	75
Total	\$12,918	\$11,846	\$4,243	\$12,097	\$203

Total Impaired Loans	\$122,512	\$79,179	\$4,243	\$88,614	\$1,701
----------------------	-----------	----------	---------	----------	---------

At December 31, 2014, the commercial impaired loan total of \$116,223,000 included \$17,027,000 in loans acquired from Community. At December 31, 2013, the commercial impaired loan total of \$119,755,000 included \$69,448,000 in loans acquired from CFS. At December 31, 2012, the commercial impaired loan total of \$79,179,000 included \$17,334,000 in loans acquired from SCB.

As part of the ongoing monitoring of the credit quality of the Corporation's loan portfolio, management tracks certain credit quality indicators including trends related to: (i) the level of criticized commercial loans, (ii) net charge offs, (iii) non-performing loans and (iv) the general national and local economic conditions.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The Corporation utilizes a risk grading of pass, special mention, substandard, doubtful and loss to assess the overall credit quality of large commercial loans. All large commercial credit grades are reviewed at a minimum of once a year for pass grade loans. Loans with grades below pass are reviewed more frequently depending on the grade. A description of the general characteristics of these grades is as follows:

**Pass** - Loans that are considered to be of acceptable credit quality.

**Special Mention** - Loans which possess some credit deficiency or potential weakness, which deserves close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Corporation's credit position at some future date. Special mention assets are not adversely classified and do not expose the Corporation to sufficient risk to warrant adverse classification. The key distinctions of this category's classification are that it is indicative of an unwarranted level of risk; and weaknesses are considered "potential", not "defined", impairments to the primary source of repayment. Examples include businesses that may be suffering from inadequate management, loss of key personnel or significant customer or litigation.

**Substandard** - A substandard loan is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness that jeopardizes the liquidation of the debt. They are characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected. Other characteristics may include:

- o the likelihood that a loan will be paid from the primary source of repayment is uncertain or financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss,
- o the primary source of repayment is gone, and the Corporation is forced to rely on a secondary source of repayment, such as collateral liquidation or guarantees,
- o loans have a distinct possibility that the Corporation will sustain some loss if deficiencies are not corrected,
- o unusual courses of action are needed to maintain a high probability of repayment,
- o the borrower is not generating enough cash flow to repay loan principal; however, it continues to make interest payments,
- o the Corporation is forced into a subordinated or unsecured position due to flaws in documentation,
- o loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms,
- o the Corporation is seriously contemplating foreclosure or legal action due to the apparent deterioration of the loan, and
- o there is significant deterioration in market conditions to which the borrower is highly vulnerable.

**Doubtful** - Loans that have all of the weaknesses of those classified as Substandard. However, based on currently existing facts, conditions and values, these weaknesses make full collection of principal highly questionable and improbable. Other credit characteristics may include the primary source of repayment is gone or there is considerable doubt as to the quality of the secondary sources of repayment. The possibility of loss is high, but because of certain important pending factors that may strengthen the loan, loss classification is deferred until the exact status of repayment is known.

**Loss** - Loans that are considered uncollectible and of such little value that continuing to carry them as an asset is not warranted. Loans will be classified as Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.



Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The following tables summarize the credit quality of the Corporation's loan portfolio, by loan class for the years indicated. Consumer non-performing loans include accruing consumer loans 90 plus days delinquent and consumer non-accrual loans. The entire balance of a loan is considered delinquent if the minimum payment contractually required to be made is not received by the specified date. Loans that evidenced deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected are included in the applicable categories below.

	December 31, 2014					Consumer Performing	Consumer Non Performing	Total
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss			
Commercial and industrial loans	\$823,732	\$ 24,455	\$ 48,226	\$ 275			\$896,688	
Agriculture production financing and other loans to farmers	96,155	1,195	7,577				104,927	
Real estate loans:								
Construction	185,394	3,164	2,928		\$ 15,588	\$ 147	207,221	
Commercial and farmland	1,552,781	29,484	90,161			235	1,672,661	
Residential	149,430	6,321	10,918		470,972	9,674	647,315	
Home equity	6,368	12	690		277,571	1,888	286,529	
Individuals' loans for household and other personal expenditures					73,165	235	73,400	
Lease financing receivables, net of unearned income	998		108				1,106	
Other loans	35,018						35,018	
Loans	\$2,849,876	\$ 64,631	\$ 160,608	\$ 275	\$ 837,296	\$ 12,179	\$3,924,865	

	December 31, 2013					Consumer Performing	Consumer Non Performing	Total
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss			
Commercial and industrial loans	\$708,835	\$ 11,332	\$ 41,013	\$ 525			\$761,705	
Agriculture production financing and other loans to farmers	114,318		30				114,348	
Real estate loans:								
Construction	162,976	1,132	12,029			\$ 945	177,082	
	1,473,714	57,676	80,184			235	1,611,809	

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Commercial and farmland							
Residential	143,657	2,232	11,494	136	\$ 448,494	10,372	616,385
Home equity	6,194	35	1,184		246,101	1,709	255,223
Individuals' loans for household and other personal expenditures					69,666	117	69,783
Lease financing receivables, net of unearned income	1,420		125				1,545
Other loans	24,334		195				24,529
Loans	\$2,635,448	\$ 72,407	\$ 146,254	\$ 661	\$ 764,261	\$ 13,378	\$3,632,409

69

---

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The following tables illustrate the past due aging of the Corporation's loan portfolio, by loan class, for the years indicated:

	December 31, 2014						Total
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual	Total Past Due & Non-Accrual	
Commercial and industrial loans	\$882,596	\$4,006	\$53	\$2,985	\$ 7,048	\$ 14,092	\$896,688
Agriculture production financing and other loans to farmers	98,236	891			5,800	6,691	104,927
Real estate loans:							
Construction	204,683	1,017	82		1,439	2,538	207,221
Commercial and farmland	1,642,016	9,846	778	671	19,350	30,645	1,672,661
Residential	626,821	4,876	1,831	854	12,933	20,494	647,315
Home equity	282,828	1,213	352	148	1,988	3,701	286,529
Individuals' loans for household and other personal expenditures	72,853	258	53	5	231	547	73,400
Lease financing receivables, net of unearned income	1,106						1,106
Other loans	35,018						35,018
Loans	\$3,846,157	\$22,107	\$3,149	\$4,663	\$ 48,789	\$ 78,708	\$3,924,865

	December 31, 2013						Total
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual	Total Past Due & Non-Accrual	
Commercial and industrial loans	\$749,020	\$2,628	\$774		\$ 9,283	\$ 12,685	\$761,705
Agriculture production financing and other loans to farmers	114,305	13			30	43	114,348
Real estate loans:							
Construction	171,046	1,058			4,978	6,036	177,082
Commercial and farmland	1,573,403	3,807	5,801	\$703	28,095	38,406	1,611,809
Residential	595,192	7,156	1,475	494	12,068	21,193	616,385
Home equity	251,188	1,652	563	153	1,667	4,035	255,223
Individuals' loans for household and other personal	69,061	550	55		117	722	69,783



expenditures							
Lease financing receivables, net of unearned income	1,545						1,545
Other loans	24,365				164	164	24,529
Loans	\$3,549,125	\$16,864	\$8,668	\$1,350	\$56,402	\$83,284	\$3,632,409

See the information regarding the analysis of loan loss experience in the "Loan Quality" and "Provision And Allowance For Loan Losses" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.

On occasion, borrowers experience declines in income and cash flow. As a result, these borrowers seek to reduce contractual cash outlays including debt payments. Concurrently, in an effort to preserve and protect its earning assets, specifically troubled loans, the Corporation is working to maintain its relationship with certain customers who are experiencing financial difficulty by contractually modifying the borrower's debt agreement with the Corporation. In certain loan restructuring situations, the Corporation may grant a concession to a debtor experiencing financial difficulty, resulting in a trouble debt restructuring. A concession is deemed to be granted when, as a result of the restructuring, the Corporation does not expect to collect all original amounts due, including interest accrued at the original contract rate. If the payment of principal at original maturity is primarily dependent on the value of collateral, the current value of the collateral is considered in determining whether the principal will be paid.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The following tables summarize troubled debt restructurings that occurred during the periods ended December 31, 2014 and 2013:

	December 31, 2014		Number of Loans
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	
Real estate loans:			
Commercial and farmland	\$259	\$ 259	1
Residential	632	622	9
Home equity	320	350	11
Individuals' loans for household and other personal expenditures	26	26	2
Total	\$1,237	\$ 1,257	23

	December 31, 2013		Number of Loans
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	
Commercial and industrial loans	\$295	\$ 316	5
Real estate loans:			
Commercial and farmland	6,506	5,492	11
Residential	809	804	12
Individuals' loans for household and other personal expenditures	143	145	4
Total	\$7,753	\$ 6,757	32

The following tables show the recorded investment of troubled debt restructurings, by modification type, that occurred during the years indicated:

	December 31, 2014			Total Modification
	Term Modification	Rate Modification	Combination	
Real estate loans:				
Commercial and farmland	\$288			\$288
Residential	31	\$218	\$360	609
Home equity		100	243	343
Individuals' loans for household and other personal expenditures			23	23
Total	\$319	\$318	\$626	\$1,263

December 31, 2013  
Combination

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

	Term Modification	Rate Modification		Total Modification
Commercial and industrial loans	\$207		\$60	\$267
Real estate loans:				
Commercial and farmland	1,388		1,985	3,373
Residential	167	\$237	351	755
Individuals' loans for household and other personal expenditures	61	38	25	124
Total	\$1,823	\$275	\$2,421	\$4,519

71

---

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Loans secured by residential real estate made up 49 percent of the post-modification balances of the troubled debt restructured loans during the twelve months ending December 31, 2014. The second largest class of troubled debt restructurings during 2014 was home equity real estate loans, which accounted for 28 percent of the total post modification balances.

The following tables summarize troubled debt restructures that occurred during the twelve months ended December 31, 2014 and 2013, that subsequently defaulted during the period indicated and remained in default at period end. For purposes of this schedule, a loan is considered in default if it is 30 or more days past due.

	Twelve Months Ended December 31, 2014	
	Number of Loans	Recorded Balance
Real estate loans:		
Residential	1	\$70
Total	1	\$70

	Twelve Months Ended December 31, 2013	
	Number of Loans	Recorded Balance
Commercial and industrial loans	3	\$173
Real estate loans:		
Commercial and farmland	2	1,034
Total	5	\$1,207

For potential consumer loan restructures, impairment evaluation occurs prior to modification. Any subsequent impairment is typically addressed through the charge off process, or may be addressed through a specific reserve. Consumer troubled debt restructurings are generally included in the general historical allowance for loan loss at the post modification balance. Consumer non-accrual and delinquent troubled debt restructurings are also considered in the calculation of the non-accrual and delinquency trend environmental allowance allocation. Commercial troubled debt restructured loans risk graded special mention, substandard, doubtful and loss are individually evaluated for impairment under ASC 310. Any resulting specific reserves are included in the allowance for loan losses. Commercial 30 - 89 day delinquent troubled debt restructurings are included in the calculation of the delinquency trend environmental allowance allocation. All commercial non-impaired loans, including non-accrual and 90+ day delinquents, are included in the ASC 450 loss migration analysis.

## NOTE 7

## ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE

The Bank acquired loans in a purchase during the years ended December 31, 2014, 2013 and 2012. The acquired loans detailed in the tables below are included in Note 6. LOANS AND ALLOWANCE, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K. As described in Note 6, loans purchased after December 31, 2008 are recorded at the acquisition date fair value, which could result in a fair value discount or premium. Purchased loans with evidence of credit deterioration since origination and for which it is probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments are accounted for under ASC 310-30, Loans Acquired with Deteriorated Credit Quality. The difference between contractually required payments and the cash flows expected to be collected at acquisition is referred to as the nonaccretable portion of the fair value discount or premium. The accretable portion of the fair value discount or premium is the difference between the expected cash flows and the net present value of expected cash flows, with such difference accreted into earnings over the term of the loans. All other loans not accounted for under ASC 310-30 are accounted for under ASC 310-20.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The following table includes the outstanding balance and carrying amount of all the performing and non-performing acquired loans, which are included in the Corporation's balance sheet at December 31, 2014 and 2013.

	December 31, 2014			December 31, 2013			
	CommunityCFS	SCB	Total	CFS	SCB	Total	
Outstanding Balance:							
Commercial and industrial loans	\$8,168	\$64,897	\$6,059	\$79,124	\$81,303	\$8,184	\$89,487
Agricultural production financing and other loans to farmers	1,100		893	1,993		1,161	1,161
Real estate loans:							
Construction	19,063	9,113		28,176	17,962		17,962
Commercial and farmland	74,600	251,002	15,593	341,195	311,631	23,418	335,049
Residential	28,863	144,396	7,384	180,643	166,754	9,359	176,113
Home Equity	9,881	39,244	15,758	64,883	49,042	18,236	67,278
Individuals' loans for household and other personal expenditures	1,314	922	121	2,357	2,360	269	2,629
Other Loans		86		86	\$132	\$407	\$539
Total	\$142,989	\$509,660	\$45,808	\$698,457	\$629,184	\$61,034	\$690,218
Carrying Amount	\$134,198	\$484,949	\$39,324	\$658,471	\$585,913	\$50,269	\$636,182
Allowance		650		650		229	229
Carrying Amount Net of Allowance	\$134,198	\$484,299	\$39,324	\$657,821	\$585,913	\$50,040	\$635,953

The balance of the allowance for loan losses and the corresponding provision expense for loans acquired and accounted for under ASC310-30 was \$650,000 and \$229,000 at December 31, 2014 and 2013, respectively.

As customer cash flow expectations improve, nonaccretable yield can be reclassified to accretable yield. The accretable yield, or income expected to be collected, and reclassifications from nonaccretable yield, are identified in the table below.

	Twelve months ended						
	December 31, 2014			December 31, 2013			December 31, 2012
	CommunityCFS	SCB	Total	CFS	SCB	Total	SCB
Beginning balance	\$13,435	\$5,864	\$19,299		\$5,142	\$5,142	\$—
Additions	\$5,687		5,687	\$13,599		13,599	
Accretion	(394 )	(6,431 )	(2,058 )	(8,883 )	(164 )	(2,071 )	(2,235 )
Reclassification from nonaccretable	119	4,501	799	5,419		2,888	2,888
Disposals		(1,594 )	(492 )	(2,086 )		(95 )	(95 )
Ending balance	\$5,412	\$9,911	\$4,113	\$19,436	\$13,435	\$5,864	\$19,299
							\$5,142

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

The following table presents loans acquired during the periods ending December 31, 2014 and 2013, for which it was probable at acquisition that all contractually required payments would not be collected:

	Community - 2014	CFS - 2013
Contractually required payments receivable at acquisition date	\$26,032	\$109,839
Nonaccretable difference	3,498	22,679
Expected cash flows at acquisition date	22,534	87,160
Accretable difference	2,234	3,502
Basis in loans at acquisition date	\$20,300	\$83,658

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 8

## PREMISES AND EQUIPMENT

The following table summarizes the Corporation's premises and equipment as of December 31, 2014 and 2013:

	2014	2013
Cost at December 31:		
Land	\$ 19,373	\$ 17,992
Buildings and Leasehold Improvements	99,451	92,693
Equipment	56,606	54,274
Total Cost	175,430	164,959
Accumulated Depreciation and Amortization	(97,739	) (90,505
Net	\$ 77,691	\$ 74,454

The Corporation is committed under various non-cancelable lease contracts for certain subsidiary office facilities and equipment. Total lease expense for 2014, 2013 and 2012 was \$3,258,000, \$2,608,000 and \$2,812,000, respectively. The future minimum rental commitments required under the operating leases in effect at December 31, 2014, expiring at various dates through the year 2028 are as follows for the years ending December 31:

	Future Minimum Rental Commitments
2015	\$ 2,778
2016	2,207
2017	1,514
2018	844
2019	537
After 2019	2,724
Total Future Minimum Obligations	\$ 10,604

## NOTE 9

## GOODWILL

On November 7, 2014, the Community acquisition resulted in goodwill of \$13,776,000. Additionally, on November 12, 2013, the CFS acquisition resulted in goodwill of \$47,573,000.

No impairment loss was recorded in 2014 or 2013. The Corporation tested goodwill for impairment during 2014 and 2013. In both valuations, the fair value exceeded the Corporation's carrying value; therefore, it was concluded goodwill is not impaired. For additional details related to impairment testing, see the "GOODWILL" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as Item 7 of this Annual Report on Form 10-K.



	2014	2013
Balance, January 1	\$188,948	\$141,375
Goodwill acquired	13,776	47,573
Balance, December 31	\$202,724	\$188,948

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 10

## CORE DEPOSIT AND OTHER INTANGIBLES

On November 7, 2014, the Community acquisition resulted in a core deposit intangible of approximately \$4,658,000. Additionally, on November 12, 2013, the CFS acquisition resulted in a core deposit intangible of approximately \$7,313,000.

The carrying basis and accumulated amortization of recognized core deposit and other intangibles are noted below.

	2014	2013
Gross carrying amount	\$53,702	\$46,389
Core deposit intangible and other intangibles acquired	4,658	7,313
Accumulated amortization	(42,329	) (39,884
Core Deposit and Other Intangibles	\$ 16,031	\$ 13,818

Amortization expense for the years ended December 31, 2014, 2013 and 2012, was \$2,445,000, \$1,649,000 and \$1,927,000, respectively.

Estimated future amortization expense is summarized as follows:

	Amortization Expense
2015	\$2,884
2016	2,817
2017	2,723
2018	1,542
2019	1,293
After 2019	4,772
Total Future Minimum Obligations	\$16,031

## NOTE 11

## DEPOSITS

The composition of the deposit portfolio is included in the table below for the years indicated:

	December 31, 2014	December 31, 2013
Demand deposits	\$2,146,492	\$2,018,650
Savings deposits	1,376,707	1,257,994
Certificates and other time deposits of \$100,000 or more	260,685	272,660
Other certificates and time deposits	523,010	595,110

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Brokered deposits	333,800	87,054
Total deposits	\$4,640,694	\$4,231,468

At December 31, 2014, the contractual maturities of time deposits are summarized as follows:

	Certificates and Other Time Deposits
2015	\$469,352
2016	256,921
2017	144,348
2018	87,234
2019	52,792
After 2019	106,848
	\$1,117,495

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 12

## BORROWINGS

The following table summarizes the Corporation's borrowings as of December 31, 2014 and 2013:

	December 31, 2014	December 31, 2013
Federal funds purchased	\$15,381	\$125,645
Securities sold under repurchase agreements	124,539	148,672
Federal Home Loan Bank advances	145,264	122,140
Subordinated debentures and term loans	126,810	126,807
Total Borrowings	\$411,994	\$523,264

Securities sold under repurchase agreements consist of obligations of the Bank to other parties. The obligations are secured by U.S. Treasury and U.S. Government-Sponsored Enterprise obligations, certain municipal securities and mortgage loans. The maximum amount of outstanding agreements at any month-end during 2014 and 2013 totaled \$155,941,000 and \$161,814,000, respectively, and the average of such agreements totaled \$130,910,000 and \$140,126,000 during 2014 and 2013, respectively.

Maturities of securities sold under repurchase agreements; Federal Home Loan Bank Advances, subordinated debentures and term loans as of December 31, 2014, are as follows:

Maturities in Years Ending December 31:	Securities Sold Under Repurchase Agreements	Federal Home Loan Bank Advances	Subordinated Debentures and Term Loans
2015	\$124,539	\$30,780	\$108
2016		41,225	
2017		15,018	
2018		25,637	
2019		12,503	
After 2019		20,101	126,702
	\$124,539	\$145,264	\$126,810

The terms of a security agreement with the FHLB require the Corporation to pledge, as collateral for advances, qualifying first mortgage loans, investment securities and multi-family loans in an amount equal to at least 146 percent of these advances depending on the type of collateral pledged. Advances, with interest rates from 0.43 to 6.81 percent, are subject to restrictions or penalties in the event of prepayment. The total available remaining borrowing capacity from the FHLB at December 31, 2014, was \$399,188,000.

Subordinated Debentures and Term Loans. As of December 31, 2014, subordinated debentures and term loans totaled \$126,810,000.

First Merchants Capital Trust II. The subordinated debenture, entered into on July 2, 2007, for \$56,702,000 will mature on September 15, 2037. The Corporation could not redeem the debenture prior to September 15, 2012, and redemption is subject to the prior approval of the Board of Governors of the Federal Reserve System, as required by law or regulation. Interest was fixed at 6.495 percent for the period from the date of issuance through September 15, 2012; interest is now an annual floating rate equal to the three-month LIBOR plus 1.56 percent, reset quarterly. Interest is payable in March, June, September and December of each year. The interest rate at December 31, 2014 was 1.8 percent. The Corporation holds all of the outstanding common securities of First Merchants Capital Trust II. On November 1, 2013, the Corporation completed the private issuance and sale to four institutional investors of an aggregate of \$70 million of debt comprised of (a) 5.00 percent Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million (the "Senior Debt") and (b) 6.75 percent Fixed-to-Floating Rate Subordinated Notes due 2028 in the aggregate principal amount of \$65 million (the "Subordinated Debt"). The interest rate on the Senior Debt and Subordinated Debt remains fixed for the first ten (10) years and will become floating thereafter. The Senior Debt agreement contains certain customary representations and warranties and financial and negative covenants. As of December 31, 2014, the Corporation was in compliance with these covenants. The net proceeds of the placement were used to pay off the Corporation's \$55 million credit facility with Bank of America, N.A. which was scheduled to mature on February 15, 2015.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Line of Credit. As of December 31, 2014, there was no outstanding balance on the line of credit.

U.S. Bank, N.A. On April 11, 2014, the Corporation entered into a line of credit agreement with U.S. Bank, N.A. with a maximum borrowing capacity of \$20 million. As of December 31, 2014, there was no outstanding balance on the line of credit. Interest is payable quarterly based on one-month LIBOR plus 2.00 percent. The line of credit has a quarterly facility fee of 0.25 percent on the unused balance. The maturity date for the line of credit is April 10, 2015. The line of credit agreement contains certain customary representations and warranties and financial and negative covenants. As of December 31, 2014, the Corporation was in compliance with these covenants.

Subordinated Debentures and Term Loans. As of December 31, 2013, subordinated debentures and term loans totaled \$126,807,000.

First Merchants Capital Trust II. The subordinated debenture, entered into on July 2, 2007, for \$56,702,000 will mature on September 15, 2037. The Corporation could not redeem the debenture prior to September 15, 2012, and redemption is subject to the prior approval of the Board of Governors of the Federal Reserve System, as required by law or regulation. Interest was fixed at 6.495 percent for the period from the date of issuance through September 15, 2012; interest is now an annual floating rate equal to the three-month LIBOR plus 1.56 percent, reset quarterly. Interest is payable in March, June, September and December of each year. The interest rate at December 31, 2013 was 1.7 percent. The Corporation holds all of the outstanding common securities of First Merchants Capital Trust II. On November 1, 2013, the Corporation completed the private issuance and sale to four institutional investors of an aggregate of \$70 million of debt comprised of (a) 5.00 percent Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million (the "Senior Debt") and (b) 6.75 percent Fixed-to-Floating Rate Subordinated Notes due 2028 in the aggregate principal amount of \$65 million (the "Subordinated Debt"). The interest rate on the Senior Debt and Subordinated Debt remains fixed for the first ten (10) years and will become floating thereafter. The Senior Debt agreement contains certain customary representations and warranties and financial and negative covenants. As of December 31, 2013, the Corporation was in compliance with these covenants. The net proceeds of the placement were used to pay off the Corporation's \$55 million credit facility with Bank of America, N.A. which was scheduled to mature on February 15, 2015.

Bank of America, N.A. The Corporation had a \$55 million credit facility with Bank of America, N.A. comprised of (a) a term loan in the principal amount of \$5 million (the "Term Loan") and (b) a subordinated debenture in the principal amount of \$50 million (the "Subordinated Debt"). Pursuant to the terms of the underlying Loan Agreement (the "Loan Agreement"), the Term Loan and the Subordinated Debt would have matured on February 15, 2015. The Term Loan was secured by a pledge of all of the issued and outstanding shares of the Bank. On November 1, 2013, the Corporation used a portion of the proceeds from the \$70 million subordinated debt placement to pay-off the Bank of America \$55 million credit facility.

NOTE 13

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

Risk Management Objective of Using Derivatives

The Corporation is exposed to certain risks arising from both its business operations and economic conditions. The Corporation principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Corporation manages economic risks, including interest rate, liquidity, and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities and through the use of derivative financial instruments. Specifically, the Corporation enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Corporation's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Corporation's known or expected cash payments principally related to certain variable-rate liabilities. The Corporation also has derivatives that are a result of a service the Corporation provides to certain qualifying customers, and, therefore, are not used to manage interest rate risk in the Corporation's assets or liabilities. The Corporation manages a matched book with respect to its derivative instruments offered as a part of this service to its customers in order to minimize its net risk exposure resulting from such transactions.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Corporation's derivative financial instruments as well as their classification on the Balance Sheet as of December 31, 2014 and December 31, 2013.

	Asset Derivatives				Liability Derivatives			
	December 31, 2014		December 31, 2013		December 31, 2014		December 31, 2013	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:								
Interest rate contracts	Other Assets	\$137	Other Assets	\$1,162	Other Liabilities	\$2,650	Other Liabilities	\$1,021
Derivatives not designated as hedging instruments:								
Interest rate contracts	Other Assets	\$3,730	Other Assets	\$2,847	Other Liabilities	\$3,887	Other Liabilities	\$2,932

## Cash Flow Hedges of Interest Rate Risk

The Corporation's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Corporation primarily uses interest rate swaps and interest rate caps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the payment of fixed amounts to a counterparty in exchange for the Corporation receiving variable payments over the life of the agreements without exchange of the underlying notional amount. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. As of December 31, 2014 and 2013, the Corporation had five interest rate swaps with a notional amount of \$56.0 million and one interest rate cap with a notional amount of \$13.0 million.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2014, \$26.0 million of the interest rate swaps and the \$13.0 million interest rate cap were used to hedge the variable cash outflows (LIBOR-based) associated with existing trust preferred securities when the outflows converted from a fixed rate to variable rate in September 2012. In addition, the remaining \$30.0 million of interest rate swaps were used to hedge the variable cash outflows (LIBOR-based) associated with three Federal Home Loan Bank advances. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. During the years ended December 31, 2014 and 2013, the Corporation did not recognize any ineffectiveness.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Corporation's variable-rate liabilities. During the next twelve months,



the Corporation expects to reclassify \$1,341,000 from accumulated other comprehensive income to interest expense.

#### Non-designated Hedges

The Corporation does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Corporation provides to certain customers. The Corporation executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Corporation executes with a third party, such that the Corporation minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of December 31, 2014, the notional amount of customer-facing swaps was approximately \$155,891,000. This amount is offset with third party counterparties, as described above.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Corporation's derivative financial instruments on the Income Statement for the years ended December 31, 2014, 2013 and 2012.

Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized in Income on Derivative	Amount of Gain (Loss) Recognized in Income on Derivative for the Year Ended December 31, 2014	Amount of Gain (Loss) Recognized in Income on Derivative for the Year Ended December 31, 2013	Amount of Gain (Loss) Recognized in Income on Derivative for the Year Ended December 31, 2012
Interest rate contracts	Other income	\$ (73 )	\$ 247	\$ (79 )

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in Other Comprehensive Income on Derivative (Effective Portion) For the Year Ended	Location of Loss Reclassified from Accumulated Other Comprehensive Income (Effective Portion)	Amount of Loss Reclassified from Other Comprehensive Income into Income (Effective Portion) For the Year Ended
	2014      2013		2014      2013      2012
Interest rate products	\$ (3,996 )    \$ 2,374	Interest expense	\$ (1,411 )    \$ (935 )    \$ (217 )

The Corporation's exposure to credit risk occurs because of nonperformance by its counterparties. The counterparties approved by the Corporation are usually financial institutions, which are well capitalized and have credit ratings through Moody's and/or Standard & Poor's, at or above investment grade. The Corporation's control of such risk is through quarterly financial reviews, comparing mark-to-market values with policy limitations, credit ratings and collateral pledging.

## Credit-Risk-Related Contingent Features

The Corporation has agreements with certain of its derivative counterparties that contain a provision where if the Corporation fails to maintain its status as a well/adequately capitalized institution, then the Corporation could be required to terminate or fully collateralize all outstanding derivative contracts. Additionally, the Corporation has agreements with certain of its derivative counterparties that contain a provision where if the Corporation defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Corporation could also be declared in default on its derivative obligations. As of December 31, 2014, the termination value of derivatives in a net liability position related to these agreements was \$6,785,000. As of December 31, 2014, the Corporation has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of \$7,411,000. If the Corporation had breached any of these provisions at December 31, 2014, it could have been required to settle its obligations under the agreements at their termination value.

NOTE 14

FAIR VALUES OF FINANCIAL INSTRUMENTS

The Corporation used fair value measurements to record fair value adjustments, to certain assets, and liabilities and to determine fair value disclosures. The accounting guidance defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. ASC 820 applies only when other guidance requires or permits assets or liabilities to be measured at fair value; it does not expand the use of fair value in any new circumstances.

As defined in ASC 820, fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants. It represents an exit price at the measurement date. Market participants are buyers and sellers, who are independent, knowledgeable, and willing and able to transact in the principal (or most advantageous) market for the asset or liability being measured. Current market conditions, including imbalances between supply and demand, are considered in determining fair value. The Corporation values its assets and liabilities in the principal market where it sells the particular asset or transfers the liability with the greatest volume and level of activity. In the absence of a principal market, the valuation is based on the most advantageous market for the asset or liability (i.e., the market where the asset could be sold or the liability transferred at a price that maximizes the amount to be received for the asset or minimizes the amount to be paid to transfer the liability).

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability. Inputs can be observable or unobservable. Observable inputs are those assumptions which market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from a source independent of the Corporation. Unobservable inputs are assumptions based on the Corporation's own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date. All inputs, whether observable or unobservable, are ranked in accordance with a prescribed fair value hierarchy which gives the highest ranking to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest ranking to unobservable inputs for which there is little or no market activity (Level 3). Fair values for assets or liabilities classified as Level 2 are based on one or a combination of the following factors: (i) quoted prices for similar assets; (ii) observable inputs for the asset or liability, such as interest rates or yield curves; or (iii) inputs derived principally from or corroborated by observable market data. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation considers an input to be significant if it drives 10 percent or more of the total fair value of a particular asset or liability.

RECURRING MEASUREMENTS

Assets and liabilities are considered to be measured at fair value on a recurring basis if fair value is measured regularly (i.e., daily, weekly, monthly or quarterly). Recurring valuation occurs at a minimum on the measurement date. Assets and liabilities are considered to be measured at fair value on a nonrecurring basis if the fair value measurement of the instrument does not necessarily result in a change in the amount recorded on the balance sheet. Generally, nonrecurring valuation is the result of the application of other accounting pronouncements which require assets or liabilities to be assessed for impairment or recorded at the lower of cost or fair value. The fair value of assets or liabilities transferred in or out of Level 3 is measured on the transfer date, with any additional changes in fair value subsequent to the transfer considered to be realized or unrealized gains or losses.

Following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying balance sheet, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Investment Securities

Where quoted, market prices are available in an active market and securities are classified within Level 1 of the valuation hierarchy. There are no securities classified within Level 1 of the hierarchy. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Level 2 securities include agencies, government-sponsored mortgage backs, state and municipal and equity securities. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy and include state and municipal, corporate obligations and equity securities. Level 3 fair value on state and municipal, corporate obligations and equity securities was determined using a discounted cash flow model that incorporated market estimates of interest rates and volatility in markets that have not been active.

Third party vendors compile prices from various sources and may apply such techniques as matrix pricing to determine the value of identical or similar investment securities (Level 2). Matrix pricing is a mathematical technique widely used in the banking industry to value investment securities without relying exclusively on quoted prices for specific investment securities but rather relying on the investment securities' relationship to other benchmark quoted investment securities. Any investment security not valued based upon the methods above are considered Level 3.

#### Corporate Obligations

In 2013, the Corporation's corporate obligations consisted primarily of pooled trust preferred securities. The issuers of these securities were primarily banks, but some of the pools did include a limited number of insurance companies. The Corporation used an other-than-temporary ("OTTI") evaluation process to compare the present value of expected cash flows to determine whether an adverse change in cash flows had occurred. The OTTI process considered the structure and term of the collateralized debt obligation ("CDO") and the financial condition of the underlying issuers. Specifically, the process detailed interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The estimated expected cash flows were based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. In 2014, the Corporation sold all but one of its trust preferred securities, which resulted in gains of \$1.9 million. These securities had previous OTTI of \$9.4 million. The one remaining trust preferred security has no remaining book value as a result of OTTI of approximately \$500,000 taken in 2009.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## Interest Rate Derivative Agreements

See information regarding the Corporation's interest rate derivative products in Note 13. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES, in the Notes to Consolidated Financial Statements included as Item 8 of this Annual Report on Form 10-K.

The following table presents the fair value measurements of assets and liabilities recognized in the accompanying balance sheets measured at fair value on a recurring basis and the level within the ASC 820-10 fair value hierarchy in which the fair value measurements fall at December 31, 2014 and 2013.

	Fair Value	Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2014				
Available for sale securities:				
U.S. Government-sponsored agency securities	\$ 109		\$ 109	
State and municipal	228,593		221,982	\$ 6,611
U.S. Government-sponsored mortgage-backed securities	319,104		319,104	
Corporate obligations	31			31
Equity securities	1,706		1,702	4
Interest rate swap asset	3,730		3,730	
Interest rate cap	137		137	
Interest rate swap liability	6,537		6,537	
		Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2013				
Available for sale securities:				
U.S. Treasury	\$ 15,973		\$ 15,973	
U.S. Government-sponsored agency securities	3,545		3,545	
State and municipal	230,987		223,752	\$ 7,235
U.S. Government-sponsored mortgage-backed securities	281,252		281,252	
Corporate obligations	2,738			2,738
Equity securities	1,706		1,702	4
Interest rate swap asset	3,619		3,619	
Interest rate cap	390		390	

Interest rate swap liability	3,953	3,953
------------------------------	-------	-------

81

---

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## LEVEL 3 RECONCILIATION

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the accompanying balance sheets using significant unobservable Level 3 inputs for year ended December 31, 2014 and 2013.

	Available for Sale Securities For The Year Ended	
	December 31, 2014	December 31, 2013
Beginning Balance	\$9,977	\$18,328
Included in other comprehensive income	3,656	1,330
Purchases, issuances, and settlements		7,590
Transfers in/(out) of Level 3		(16,434 )
Principal payments	(6,987 )	(837 )
Ending balance	\$6,646	\$9,977

There were no gains or losses for the period included in earnings that were attributable to the changes in unrealized gains or losses related to assets or liabilities held at December 31, 2014 or 2013.

## TRANSFERS BETWEEN LEVELS

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Reason for Transfer
December 31, 2013 Transfers to/(from) Level:				
Available for sale securities		\$(350 )	\$350	Selected state and municipal securities were transferred from Level 2 to Level 3 due to limited availability of similar securities in active markets.
Available for sale securities transferred to held to maturity			\$(16,784 )	Selected state and municipal securities were transferred from available for sale to held to maturity. These securities are valued at amortized cost and are no longer classified within the fair value hierarchy.

In 2013, approximately \$350,000 of selected state and municipal securities were transferred from Level 2 to Level 3 due to limited availability of similar securities in active markets. Additionally, the Corporation transferred



\$16,784,000 of selected state and municipal securities from available for sale to held to maturity. These securities are valued at amortized cost and are no longer classified within the fair value hierarchy. All securities transferred to held to maturity were previously classified as Level 3 in the fair value hierarchy. There were no transfers in or out of Level 3 during 2014.

#### NONRECURRING MEASUREMENTS

Following is a description of valuation methodologies used for instruments measured at fair value on a non-recurring basis and recognized in the accompanying balance sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy for year ended December 31, 2014 and 2013.

		Fair Value Measurements Using		
		Quoted Prices in Active	Significant	Significant
		Markets for Identical	Other	Unobservable
		Assets	Observable	Inputs
		(Level 1)	Inputs	(Level 3)
	Fair Value		(Level 2)	
December 31, 2014				
Impaired Loans (collateral dependent)	\$17,134			\$17,134
Other real estate owned	\$5,155			\$5,155
		Fair Value Measurements Using		
		Quoted Prices in Active	Significant	Significant
		Markets for Identical	Other	Unobservable
		Assets	Observable	Inputs
		(Level 1)	Inputs	(Level 3)
	Fair Value		(Level 2)	
December 31, 2013				
Impaired Loans (collateral dependent)	\$12,117			\$12,117
Other real estate owned	\$6,877			\$6,877

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## Impaired Loans (collateral dependent)

Loans for which it is probable that the Corporation will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for determining the amount of impairment include estimating fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of the loan is confirmed. During 2014, certain impaired loans were partially charged off or re-evaluated. Impaired loans that are collateral dependent are classified within Level 3 of the fair value hierarchy when impairment is determined using the fair value method.

## Other Real Estate Owned

The fair value for impaired loans and other real estate owned is measured based on the value of the collateral securing those loans or real estate and is determined using several methods. The fair value of real estate is generally determined based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically ascertained by assessing, either singularly or some combination of, asset appraisals, accounts receivable aging reports, inventory listings and or customer financial statements. Both appraised values and values based on borrower's financial information are discounted as considered appropriate based on age and quality of the information and current market conditions.

## UNOBSERVABLE (LEVEL 3) INPUTS

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements, other than goodwill, at December 31, 2014 and 2013.

December 31, 2014	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)
State and municipal securities	\$6,611	Discounted cash flow	Maturity Call Date US Muni BQ curve Discount rate	1 month to 15 years A- to BBB- .90% - 5%
Corporate obligations and Equity securities	\$35	Discounted cash flow	Risk free rate plus Premium for illiquidity	3 month LIBOR plus 200 bps
Impaired loans (collateral dependent)	\$17,134	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 50% (3%)

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

December 31, 2013	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)
Other real estate owned	\$5,155	Appraisals	Discount to reflect current market conditions	0% - 20% (7%)
State and municipal securities	\$7,235	Discounted cash flow	Maturity Call Date US Muni BQ curve Discount rate	1 month to 15 years A- to BBB- 1% - 5%
Corporate obligations and Equity securities	\$2,742	Discounted cash flow	Risk free rate plus Premium for illiquidity	3 month LIBOR plus 200 bps
Impaired loans (collateral dependent)	\$12,117	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 50% (3%)
Other real estate owned	\$6,877	Appraisals	Discount to reflect current market conditions	0% - 20% (2%)

The following is a discussion of the sensitivity of significant unobservable inputs, the interrelationships between those inputs and other unobservable inputs used in recurring fair value measurement and how those inputs might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

State and Municipal Securities, Corporate Obligations and Equity Securities

The significant unobservable inputs used in the fair value measurement of the Corporation's state and municipal securities, corporate obligations and equity securities are premiums for unrated securities and marketability discounts. Significant increases or decreases in either of those inputs in isolation would result in a significantly lower or higher fair value measurement. Generally, changes in either of those inputs will not affect the other input.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table presents estimated fair values of the Corporation's financial instruments and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2014 and 2013.

	2014			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at December 31:				
Cash and cash equivalents	\$ 118,616	\$ 118,616		
Interest-bearing time deposits	47,520	47,520		
Investment securities available for sale	549,543		\$ 542,897	\$ 6,646
Investment securities held to maturity	631,088		614,457	33,266
Loans held for sale	7,235		7,235	
Loans	3,860,901			3,810,912
FRB and FHLB stock	41,353		41,353	
Interest rate swap asset	3,867		3,867	
Interest receivable	19,984		19,984	
Liabilities at December 31:				
Deposits	\$ 4,640,694	\$ 3,523,199	\$ 1,099,610	
Borrowings:				
Federal funds purchased	15,381		15,381	
Securities sold under repurchase agreements	124,539		124,539	
FHLB Advances	145,264		146,669	
Subordinated debentures and term loans	126,810		92,802	
Interest rate swap liability	6,537		6,537	
Interest payable	3,201		3,201	
	2013			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at December 31:				
Cash and cash equivalents	\$ 109,434	\$ 109,434		
Interest-bearing time deposits	55,069	55,069		
Investment securities available for sale	536,201		\$ 526,224	\$ 9,977
Investment securities held to maturity	559,378		525,998	34,849
Loans held for sale	5,331		5,331	

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Loans	3,564,539		3,506,615
FRB and FHLB stock	38,990	38,990	
Interest rate swap asset	4,009	4,009	
Interest receivable	18,672	18,672	
Liabilities at December 31:			
Deposits	\$4,231,468	\$3,082,117	\$934,937
Borrowings:			
Federal funds purchased	125,645	125,645	
Securities sold under repurchase agreements	148,672	148,852	
FHLB Advances	122,140	122,962	
Subordinated debentures and term loans	126,807	82,607	
Interest rate swap liability	3,953	3,953	
Interest payable	1,771	1,771	

The following methods were used to estimate the fair value of all other financial instruments recognized in the Consolidated Condensed Balance Sheets at amounts other than fair value.

Cash and cash equivalents: The fair value of cash and cash equivalents approximates carrying value.

Interest-bearing time deposits: The fair value of interest-bearing time deposits approximates carrying value.

Investment securities: Fair value is based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The fair value of certain Level III securities is estimated using discounted cash flow analysis, using interest rates currently being offered on investments with similar maturities and investment quality.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Mortgage loans held for sale: The carrying amount approximates fair value due to the short duration between origination and date of sale.

Loans: The fair value for loans is estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. See Impaired Loans above.

Federal Reserve and Federal Home Loan Bank stock: The fair value of Federal Reserve Bank and Federal Home Loan Bank stock is based on the price which it may be resold to the Federal Reserve and Federal Home Loan Bank.

Derivative instruments: The fair value of interest rate swaps reflect the estimated amounts that would have been received to terminate these contracts at the reporting date based upon pricing or valuation models applied to current market information. Interest rate caps are valued using the market standard methodology of discounting the future expected cash receipts that would occur if variable interest rates rose above the strike rate of the caps. The projected cash receipts on the caps are based on an expectation of future interest rates derived from observed market interest rate curves and volatilities.

Interest receivable and Interest payable: The fair value of interest receivable/payable approximates carrying value.

Deposits: The fair values of noninterest-bearing and interest-bearing demand accounts and savings deposits are equal to the amount payable on demand at the balance sheet date. The carrying amounts for variable rate, fixed-term certificates of deposit approximate their fair values at the balance sheet date. Fair values for fixed-rate certificates of deposit and other time deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered to a schedule of aggregated expected monthly maturities on such time deposits.

Borrowings: The fair value of Federal Funds purchased approximates the carrying amount. The fair value of all other borrowings is estimated using a discounted cash flow calculation, based on current rates for similar debt.

NOTE 15

COMMITMENTS AND CONTINGENT LIABILITIES

In the normal course of business there are outstanding commitments and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying financial statements. The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as they do for instruments that are included in the consolidated balance sheets.

Financial instruments, whose contract amount represents credit risk as of December 31, were as follows:

	2014	2013
Amounts of commitments:		
Loan commitments to extend credit	\$1,617,552	\$1,216,470

Standby letters of credit	\$52,655	\$41,508
---------------------------	----------	----------

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies, but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party.

The Corporation and subsidiaries are also subject to claims and lawsuits, which arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the consolidated financial position of the Corporation.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

NOTE 16

STOCKHOLDERS' EQUITY

National banking laws restrict the maximum amount of dividends that a bank may pay in any calendar year. National banks are limited to the bank's retained net income (as defined) for the current year plus those for the previous two years. The amount at December 31, 2014, available for 2015 dividends from the Corporation's subsidiaries (both banking and non-banking) was \$23,340,000.

Total stockholders' equity for all subsidiaries at December 31, 2014, was \$818,420,000 of which \$795,080,000 was restricted from dividend distribution to the Corporation.

The Corporation has a Dividend Reinvestment and Stock Purchase Plan, enabling stockholders to elect to have their cash dividends on all shares automatically reinvested in additional shares of the Corporation's common stock. In addition, stockholders may elect to make optional cash payments up to an aggregate of \$2,500 per quarter for the purchase of additional shares of common stock. The stock is credited to participant accounts at fair market value. Dividends are reinvested on a quarterly basis.

Preferred Stock

On September 22, 2011, the Corporation entered into a Securities Purchase Agreement (the "Purchase Agreement") with the Treasury, pursuant to which the Corporation issued 90,782.94 shares of the Corporation's Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock"), having a liquidation amount per share equal to \$1,000, for a total purchase price of \$90,782,940. The Purchase Agreement was entered into, and the Series B Preferred Stock was issued, pursuant to the SBLF program, a \$30 billion fund established under the Small Business Jobs Act of 2010, that encourages lending to small businesses by providing capital to qualified community banks with assets of less than \$10 billion.

On January 3, 2013, the Corporation redeemed 22,695.94 shares of the Series B Preferred Stock held by the Treasury at an aggregate redemption price of \$22,695,940 plus accrued but unpaid dividends. Following the redemption, the Treasury held 68,087 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately \$68 million.

On July 2, 2013, the Corporation redeemed an additional 34,044 shares of the Series B Preferred Stock held by the Treasury at an aggregate redemption price of \$34,044,000 plus accrued but unpaid dividends. Following the redemption, the Treasury held 34,043 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately \$34 million.

On November 22, 2013, the Corporation redeemed the final 34,043 shares of the Series B Preferred Stock held by the Treasury at an aggregate redemption price of \$34,043,000 plus accrued but unpaid dividends. There are no shares of the Corporation's Series B Preferred Stock currently outstanding.

CFS Acquisition



On November 12, 2013, the Corporation acquired 100 percent of CFS Bancorp, Inc. ("CFS") in an all stock transaction. Pursuant to the merger agreement, the shareholders of CFS received 0.65 percent of a share of the Corporation's common stock for each share of CFS Bancorp common stock held. The Corporation issued approximately 7.1 million shares of common stock, which was valued at approximately \$135.6 million.

#### Community Acquisition

On November 7, 2014, the Corporation acquired 100 percent of Community Bancshares, Inc. ("Community"). Pursuant to the merger agreement, each outstanding share of common stock of Community was converted into the right to receive either (a) 4.0926 shares of First Merchants' common stock, plus cash in lieu of fractional shares; or (b) \$85.94 in cash, based upon shareholder elections. The Corporation paid \$14.2 million in cash and issued approximately 1.6 million shares of common stock, valued at approximately \$35.0 million, for a total purchase price of approximately \$49.2 million.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 17

## ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table summarizes the changes in the balances of each component of accumulated other comprehensive income (loss), net of tax, as of December 31, 2014 and 2013:

	Accumulated Other Comprehensive Income (Loss)				
	Unrealized Gains (Losses) on Securities Available for Sale	Unrealized Gains (Losses) on Securities Available for Sale for which a Portion of Other-Than-Temporary Impairment has been Recognized in Income	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans	Total
Balance at December 31, 2013	\$1,566	\$ (1,847 )	\$ (501 )	\$ (5,628 )	\$ (6,410 )
Other comprehensive income before reclassifications	14,860	1,847	(2,599 )	(7,580 )	6,528
Amounts reclassified from accumulated other comprehensive income	(2,328 )		918	(338 )	(1,748 )
Period change	12,532	1,847	(1,681 )	(7,918 )	4,780
Balance at December 31, 2014	\$14,098	\$ —	\$ (2,182 )	\$ (13,546 )	\$ (1,630 )
Balance at December 31, 2012	\$17,904	\$ (3,272 )	\$ (2,652 )	\$ (17,479 )	\$ (5,499 )
Other comprehensive income before reclassifications	(16,021 )	1,425	1,543	10,704	(2,349 )
Amounts reclassified from accumulated other comprehensive income	(317 )		608	1,147	1,438
Period change	(16,338 )	1,425	2,151	11,851	(911 )
Balance at December 31, 2013	\$1,566	\$ (1,847 )	\$ (501 )	\$ (5,628 )	\$ (6,410 )

The following table presents the reclassification adjustments out of accumulated other comprehensive income (loss) that were included in net income in the Consolidated Condensed Statements of Income for the twelve months ended December 31, 2014, 2013 and 2012:

Details about Accumulated Other Comprehensive Income (Loss) Components	Amount Reclassified from Accumulated Other Comprehensive Income (Loss) For the Year Ended December 31,			Affected Line Item in the Statements of Income
	2014	2013	2012	

Unrealized gains (losses) on available for sale securities (1)				
Realized securities gains reclassified into income	\$3,581	\$487	\$2,389	Other income - net realized gains on sales of available for sale securities
Related income tax expense	(1,253 )	(170 )	(835 )	Income tax expense
	\$2,328	\$317	\$1,554	
Unrealized gains (losses) on cash flow hedges (2)				
Interest rate contracts	\$(1,411 )	\$(935 )	\$(217 )	Interest expense - subordinated debentures and term loans
Related income tax benefit	493	327	76	Income tax expense
	\$(918 )	\$(608 )	\$(141 )	
Unrealized gains (losses) on defined benefit plans				
Amortization of net loss and prior service costs	\$520	\$(1,765 )	\$100	Other expenses - salaries and employee benefits
Related income tax benefit (expense)	(182 )	618	(35 )	Income tax expense
	\$338	\$(1,147 )	\$65	
Total reclassifications for the period, net of tax	\$1,748	\$(1,438 )	1,478	

(1) For additional detail related to unrealized gains (losses) on available for sale securities and related amounts reclassified from accumulated other comprehensive income see Note 5. INVESTMENT SECURITIES.

(2) For additional detail related to unrealized gains (losses) on cash flow hedges and related amounts reclassified from accumulated other comprehensive income see Note 13. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 18

## REGULATORY CAPITAL

The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies and are assigned to a capital category. The assigned capital category is largely determined by three ratios that are calculated according to the regulations: total risk adjusted capital, Tier 1 capital, and Tier 1 leverage ratios. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to an entity can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios.

There are five capital categories defined in the regulations, ranging from well capitalized to critically undercapitalized. Classification of a bank in any of the undercapitalized categories can result in actions by regulators that could have a material effect on a bank's operations.

At December 31, 2014, the management of the Corporation believes that it meets all capital adequacy requirements to which it is subject. The most recent notifications from the regulatory agencies categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, a bank must maintain a minimum total capital to risk-weighted assets, Tier I capital to risk-weighted assets and Tier I capital to average assets of 10 percent, 6 percent and 5 percent, respectively. It should be noted that a bank's capital category is determined solely for the purpose of applying the OCC's "prompt corrective action" regulations and that the capital category may not constitute an accurate representation of the Bank's overall financial condition or prospects.

Actual and required capital amounts and ratios are listed below.

	2014				2013				
	Actual Amount	Ratio	Required For Adequate Capital Amount	Ratio	Actual Amount	Ratio	Required For Adequate Capital Amount	Ratio	
December 31, Total Capital (to Risk-weighted Assets)									
First Merchants Corporation	\$685,507	15.34	% \$357,581	8.00	% \$599,966	14.54	% \$330,107	8.00	%
First Merchants Bank	653,169	14.64	356,884	8.00	599,272	14.56	329,344	8.00	
Tier I Capital (to Risk-weighted Assets)									
First Merchants Corporation	\$564,535	12.63	% \$178,791	4.00	% \$483,186	11.71	% \$165,053	4.00	%
First Merchants Bank	597,305	13.39	178,442	4.00	547,655	13.30	164,672	4.00	
Tier I Capital (to Average Assets)									
First Merchants Corporation	\$564,535	10.15	% \$222,533	4.00	% \$483,186	10.20	% \$189,485	4.00	%

First Merchants Bank	597,305	10.56	226,339	4.00	547,655	11.58	189,095	4.00
----------------------	---------	-------	---------	------	---------	-------	---------	------

## NOTE 19

## LOAN SERVICING

Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The loans are serviced primarily for the Federal Home Loan Mortgage Corporation and Fannie Mae, and the unpaid balances totaled \$254,223,000, \$271,871,000 and \$167,879,000 at December 31, 2014, 2013 and 2012, respectively. The amount of capitalized servicing assets is considered immaterial.

## NOTE 20

## SHARE-BASED COMPENSATION

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1999 Long-term Equity Incentive Plan and the 2009 Long-term Equity Incentive Plan. The stock options, which have a ten-year life, become 100 percent vested ranging from six months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs issued to employees and non-employee directors provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after three years. The RSAs vest only if the employee is actively employed by the Corporation on the vesting date and, therefore, any unvested shares are forfeited. For non-employee directors, the RSA's vest only if the non-employee director remains as an active board member on the vesting date and, therefore, any unvested shares are forfeited. RSAs for employees and non-employee directors retired from the Corporation are either immediately vested at retirement or continue to vest after retirement, depending on the plan under which the shares were granted. Deferred stock units ("DSUs") can be credited to non-employee directors who elect to defer payment of compensation under the Corporation's 2008 Equity Compensation Plan for Non-employee Directors. DSUs credited are equal to the restricted shares that the non-employee director would have received under the plan. As of December 31, 2014, the Corporation did not have any outstanding DSUs.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The Corporation's 2009 Employee Stock Purchase Plan ("ESPP") provides eligible employees of the Corporation and its subsidiaries an opportunity to purchase shares of common stock of the Corporation through quarterly offerings financed by payroll deductions. The price of the stock to be paid by the employees shall be equal to 85 percent of the average of the closing price of the Corporation's common stock on each trading day during the offering period. However, in no event shall such purchase price be less than the lesser of an amount equal to 85 percent of the market price of the Corporation's stock on the offering date or an amount equal to 85 percent of the market value on the date of purchase. Common stock purchases are made quarterly and are paid through advance payroll deductions up to a calendar year maximum of \$25,000.

Compensation expense related to unvested share-based awards is recorded by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the years ended December 31, 2014, 2013, and 2012 was \$2,177,000, \$1,773,000, and \$1,492,000, respectively, and has been recognized as a component of salaries and benefits expense in the accompanying CONSOLIDATED STATEMENTS OF INCOME.

The estimated fair value of the stock options granted during 2014, 2013, and 2012 was calculated using a Black-Scholes option pricing model. The following summarizes the assumptions used in the Black-Scholes model:

	2014		2013		2012	
Risk-free interest rate	2.41	%	1.25	%	1.36	%
Expected price volatility	45.05	%	45.68	%	46.22	%
Dividend yield	2.73	%	2.96	%	3.29	%
Forfeiture rate	5.46	%	4.73	%	4.77	%
Weighted-average expected life, until exercise	7.74	years	7.27	years	7.20	years

The Black-Scholes model incorporates assumptions used to value share-based awards. The risk-free rate of interest, for periods equal to the expected life of the option, is based on a U.S. government instrument over a similar contractual term of the equity instrument. Expected price volatility is based on historical volatility of the Corporation's common stock. In addition, the Corporation generally uses historical information to determine the dividend yield and weighted-average expected life of the options until exercise. Separate groups of employees that have similar historical exercise behavior with regard to option exercise timing and forfeiture rates are considered separately for valuation and attribution purposes.

Share-based compensation expense recognized in the CONSOLIDATED STATEMENTS OF INCOME is based on awards ultimately expected to vest and is reduced for estimated forfeitures. Share-based compensation guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately 5.5 percent for the year ended December 31, 2014, based on historical experience.

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

The following table summarizes the components of the Corporation's share-based compensation awards recorded as expense:

	Year Ended December 31, 2014	Year Ended December 31, 2013	Year Ended December 31, 2012
Stock and ESPP Options			
Pre-tax compensation expense	\$237	\$253	\$284
Income tax benefit	(47	) (16	) (23
Stock and ESPP option expense, net of income taxes	\$190	\$237	\$261
Restricted Stock Awards			
Pre-tax compensation expense	\$1,940	\$1,520	\$1,208
Income tax benefit	(679	) (531	) (428
Restricted stock awards expense, net of income taxes	\$1,261	\$989	\$780
Total Share-Based Compensation:			
Pre-tax compensation expense	\$2,177	\$1,773	\$1,492
Income tax benefit	(726	) (547	) (451
Total share-based compensation expense, net of income taxes	\$1,451	\$1,226	\$1,041

As of December 31, 2014, unrecognized compensation expense related to stock options and RSAs totaling \$4,000 and \$2,618,000, respectively, is expected to be recognized over weighted-average periods of 0.14 years and 1.16 years, respectively.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Stock option activity under the Corporation's stock option plans, as of December 31, 2014, and changes during the year ended December 31, 2014, were as follows:

	Number of Shares	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2014	958,786	\$ 21.32		
Granted	13,500	\$ 21.65		
Exercised	(41,249 )	\$ 12.21		
Canceled	(193,106 )	\$ 24.42		
Outstanding December 31, 2014	737,931	\$ 20.99	3.08	2,645,356
Vested and Expected to Vest at December 31, 2014	737,931	\$ 20.99	3.08	2,645,356
Exercisable at December 31, 2014	715,431	\$ 21.05	2.90	2,563,636

The weighted-average grant date fair value was \$8.13, \$5.73 and \$3.97 for stock options granted during the years ended December 31, 2014, 2013 and 2012, respectively.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Corporation's closing stock price on the last trading day of 2014 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their stock options on December 31, 2014. The amount of aggregate intrinsic value will change based on the fair market value of the Corporation's common stock.

The aggregate intrinsic value of stock options exercised during the years ended December 31, 2014 and 2013 was \$392,000 and \$143,000, respectively. Cash receipts of stock options exercised during 2014 and 2013 were \$504,000 and \$115,000, respectively.

The following table summarizes information on unvested RSAs outstanding as of December 31, 2014:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested RSAs at January 1, 2014	429,002	\$12.51
Granted	98,611	\$20.54
Forfeited	(9,717 )	\$15.78
Vested	(132,446 )	\$9.16
Unvested RSAs at December 31, 2014	385,450	\$15.65



The grant date fair value of ESPP options was estimated at the beginning of the October 1, 2014, quarterly offering period of approximately \$20,000. The ESPP options vested during the three months ending December 31, 2014, leaving no unrecognized compensation expense related to unvested ESPP options at December 31, 2014.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 21

## PENSION AND OTHER POST RETIREMENT BENEFIT PLANS

The Corporation's defined-benefit pension plans cover approximately 25 percent of the Corporation's employees. In 2005, the Board of Directors of the Corporation approved the curtailment of the accumulation of defined benefits for future services provided by certain participants in the First Merchants Corporation Retirement Plan. No additional pension benefits have been earned by any employees who had not attained both the age of 55 and accrued at least 10 years of vesting service as of March 1, 2005. The benefits are based primarily on years of service and employees' pay near retirement. Contributions are intended to provide not only for benefits attributed to service-to-date, but also for those expected to be earned in the future. The Corporation also maintains post retirement benefit plans that provide health insurance benefits to retirees. The plans allow retirees to be carried under the Corporation's health insurance plan, generally from ages 55 to 65. The retirees pay 100 percent of the premiums due for their coverage. The table below sets forth the plans' funded status and amounts recognized in the consolidated balance sheets at December 31, using measurement dates of December 31, 2014 and 2013.

	2014	2013
Change in Benefit Obligation:		
Benefit obligation at beginning of year	\$62,270	\$69,166
Service cost	73	131
Interest cost	3,235	2,670
Actuarial loss (gain)	12,968	(5,597 )
Benefits paid	(5,541 )	(4,100 )
Net transfers in from CFS acquisition	7,645	
Benefit obligation at end of year	\$80,650	\$62,270
Change in Plan Assets:		
Fair value of plan assets at beginning of year	\$69,871	\$62,865
Actual return on plan assets	5,232	10,610
Employer contributions	504	496
Benefits paid	(5,541 )	(4,100 )
CFS acquisition	7,073	
End of year	77,139	69,871
Funded status at end of year	\$(3,511 )	\$7,601
Assets and Liabilities Recognized in the Balance Sheets:		
Deferred tax asset	\$8,541	\$4,266
Assets	\$1,329	\$12,383
Liabilities	\$4,840	\$4,782
Amounts Recognized in Accumulated Other Comprehensive Income Not Yet Recognized as Components of Net Periodic (Benefit) Cost Consist of:		
Accumulated loss	\$(15,863 )	\$(7,922 )
Prior service credit	(346 )	(28 )
	\$(16,209 )	\$(7,950 )

The actuarial loss recognized in 2014 was primarily due to two factors. The first factor was a decrease in the discount rate assumption from 4.80% at December 31, 2013 to 4.00% at December 31, 2014. The second factor contributing to the loss was the Corporation's adoption of the Society of Actuaries new mortality tables.

Citizens Financial Bank participated in the Pentegra Defined Benefit Plan for Financial Institutions (the "Pentegra Plan"), an industry-wide, tax-qualified defined-benefit pension plan. The Pentegra Plan operated as a multi-employer plan for accounting purposes and as a multiple employer plan under ERISA and the Internal Revenue Code. On September 30, 2013, the Board of Citizens Financial Bank approved a resolution to withdraw as a Participating Employer in the Pentegra Plan. Upon completion of the withdrawal from the Pentegra Plan, the assets and liabilities were merged into the First Merchants Corporation Retirement Plan in early 2014.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The accumulated benefit obligation for all defined benefit plans was \$80,650,000 and \$62,263,000 at December 31, 2014 and 2013, respectively.

Information for pension plans with an accumulated benefit obligation in excess of plan assets is included in the table below.

	December 31, 2014	December 31, 2013
Projected benefit obligation	\$4,840	\$4,782
Accumulated benefit obligation	\$4,840	\$4,782
Fair value of plan assets		

The following table shows the components of net periodic pension costs:

	December 31, 2014	December 31, 2013	December 31, 2012
Service cost	\$73	\$131	\$161
Interest cost	3,235	2,670	2,990
Expected return on plan assets	(4,467	) (4,265	) (4,216
Amortization of prior service costs	81	25	25
Amortization of net loss	478	2,131	2,207
Net periodic pension (benefit) cost	\$(600	) \$692	\$1,167

Other changes in plan assets and benefit obligations recognized in other comprehensive income (loss):

	December 31, 2014	December 31, 2013	December 31, 2012
Net periodic pension (benefit) cost	\$(600	) \$692	\$1,167
Net gain (loss)	(12,203	) 11,942	(1,242
Amortization of loss	478	2,131	2,207
Amortization of prior service cost	81	25	25
Total recognized in other comprehensive income (loss)	(11,644	) 14,098	990
Total recognized in net periodic pension cost and other comprehensive income (loss)	\$(11,044	) \$13,406	\$(177

The estimated net loss and transition obligation for the defined benefit pension plans that will be amortized from accumulated other comprehensive income into net periodic pension cost over the next fiscal year are:

	December 31, 2014	December 31, 2013	December 31, 2012
Amortization of net loss	\$(1,770	) \$(533	) \$(2,158
Amortization of prior service cost	(64	) (25	) (25
Total	\$(1,834	) \$(558	) \$(2,183

Significant assumptions include:

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

	December 31, 2014	December 31, 2013	December 31, 2012	
Weighted-average Assumptions Used to Determine Benefit Obligation:				
Discount rate	4.00	% 4.80	% 4.00	%
Rate of compensation increase for accruing active participants	3.00	% 3.00	% 3.00	%
Weighted-average Assumptions Used to Determine Cost:				
Discount rate	4.80	% 4.00	% 4.50	%
Expected return on plan assets	6.00	% 7.00	% 7.00	%
Rate of compensation increase for accruing active participants	3.00	% 3.00	% 4.00	%

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

At December 31, 2014 and 2013, the Corporation based its estimate of the expected long-term rate of return on analysis of the historical returns of the plans and current market information available. The plans' investment strategies are to provide for preservation of capital with an emphasis on long-term growth without undue exposure to risk. The assets of the plans' are invested in accordance with the plans' Investment Policy Statement, subject to strict compliance with Employee Retirement Income Security Act of 1974 ("ERISA") and any other applicable statutes.

The plans' risk management practices include quarterly evaluations of investment managers, including reviews of compliance with investment manager guidelines and restrictions; ability to exceed performance objectives; adherence to the investment philosophy and style; and ability to exceed the performance of other investment managers. The evaluations are reviewed by management with appropriate follow-up and actions taken, as deemed necessary. The Investment Policy Statement generally allows investments in cash and cash equivalents, real estate, fixed income debt securities and equity securities, and specifically prohibits investments in derivatives, options, futures, private placements, short selling, non-marketable securities and purchases of non-investment grade bonds.

At December 31, 2014, the maturities of the plans' debt securities ranged from 15 days to 9.59 years, with a weighted average maturity of 5.02 years. At December 31, 2013, the maturities of the plans' debt securities ranged from 2 days to 9.61 years, with a weighted average maturity of 4.63 years.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as of December 31, 2014. The minimum contribution required in 2015 will likely be zero but the Corporation may decide to make a discretionary contribution during the year.

2015	\$4,761
2016	4,757
2017	4,751
2018	4,783
2019	4,997
After 2019	25,125
	\$49,174

Plan assets are re-balanced quarterly. At December 31, 2014 and 2013, plan assets by category are as follows:

	December 31, 2014		December 31, 2013			
	Actual	Target	Actual	Target		
Cash and cash equivalents	2.6	% 2.0	% 2.7	% 2.0		%
Equity securities	58.7	60.0	62.2	60.0		
Debt securities	36.5	36.0	33.2	36.0		
Alternative investments	2.2	2.0	1.9	2.0		
	100.0	% 100.0	% 100.0	% 100.0		%

The First Merchants Corporation Retirement and Income Savings Plan (the "Savings Plan"), a Section 401(k) qualified defined contribution plan, was amended on March 1, 2005 to provide enhanced retirement benefits, including

employer and matching contributions, for eligible employees of the Corporation and its subsidiaries. The Corporation matches employees' contributions primarily at the rate of 50 percent for the first 6 percent of base salary contributed by participants.

Beginning in 2005, employees who have completed 1000 hours of service and are an active employee on the last day of the year receive an additional retirement contribution after year-end. Employees hired after January 1, 2010 do not participate in the additional retirement contribution. Effective January 1, 2013, the additional retirement contribution was fixed at 2 percent. Full vesting occurs after five years of service. The Corporation's expense for the Savings Plan, including the additional retirement contribution, was \$3,396,000, \$3,138,000 and \$2,914,000 for 2014, 2013 and 2012, respectively.

The Corporation maintains post retirement benefit plans that provide health insurance benefits to retirees. The plans allow retirees to be carried under the Corporation's health insurance plan, generally from ages 55 to 65. The retirees pay 100 percent of the premiums due for their coverage. The obligations payable under the plans totaled \$1,811,000 and \$1,534,000 at December 31, 2014 and 2013, respectively. Post retirement plan expense totaled \$97,000, \$519,000 and \$477,000 for the years ending December 31, 2014, 2013 and 2012, respectively.





Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

December 31, 2013	Fair Value	Markets for Identical Assets (Level 1)	Inputs (Level 2)	(Level 3)
Cash & Cash Equivalents	\$1,864	\$1,864		
Corporate Bonds and Notes	6,076	6,076		
Government Agency and Municipal Bonds and Notes	8,263		\$8,263	
Certificates of Deposit	607		607	
Party-in-Interest Investments				
Common Stock	1,375	1,375		
Common Bond Fund	5,318		5,318	
Common Equity Fund	4,507		4,507	
Mutual Funds				
Taxable Bond	3,901	3,901		
Large Cap Equity	20,617	20,617		
Mid Cap Equity	8,721	8,721		
Small Cap Equity	3,584	3,584		
International Equity	3,727	3,727		
Specialty Alternative Equity	1,311	1,311		
	\$69,871	\$51,176	\$18,695	\$—

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 22

## INCOME TAX

The reconciliation between the statutory and actual income tax expense (benefit) is summarized in the following table for the years indicated:

	2014	2013	2012
Income Tax Expense for the Year Ended December 31:			
Currently Payable:			
Federal	\$(1,661	) \$738	\$(23
State			)
Deferred:			
Federal	22,541	13,939	15,890
State	510		
Total Income Tax Expense	\$21,390	\$14,677	\$15,867
Reconciliation of Federal Statutory to Actual Tax Expense:			
Federal Statutory Income Tax at 35%	\$28,543	\$20,722	\$21,347
Tax-exempt Interest Income	(5,148	) (3,923	) (3,716
Stock Compensation	36	50	76
Earnings on Life Insurance	(1,271	) (905	) (1,187
Tax Credits	(911	) (857	) (73
Other	141	(410	) (580
Actual Tax Expense	\$21,390	\$14,677	\$15,867

Tax expense applicable to security gains and losses, including unrealized losses relating to other-than-temporary impairment charges, for the years ended December 31, 2014, 2013 and 2012, was \$760,000, \$157,000 and \$759,000, respectively.

The Corporation or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. With a few exceptions, the Corporation is no longer subject to U.S. federal, state and local or non-U.S. income tax examinations by tax authorities for years before 2011.

The tax effects of temporary differences related to deferred taxes shown on the balance sheets were:

	2014	2013
Deferred Tax Asset at December 31:		
Assets:		
Differences in Accounting for Loan Losses	\$26,665	\$28,064
Differences in Accounting for Loan Fees	747	736
Differences in Accounting for Loans and Securities	9,910	13,579
Deferred Compensation	5,234	5,479
Difference in Accounting for Pensions and Other Employee Benefits	1,084	
Federal & State Income Tax Loss Carryforward and Credits	23,977	24,981

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Net Unrealized Loss on Securities Available for Sale		151	
Other	8,535	12,828	
Total Assets	76,152	85,818	
Liabilities:			
Differences in Depreciation Methods	8,220	8,008	
Difference in Accounting for Pensions and Other Employee Benefits		1,096	
State Income Tax	591	354	
Net Unrealized Gain on Securities Available for Sale	7,591		
Gain on FDIC Modified Whole Bank Transaction	1,694	2,147	
Other	1,096	1,257	
Total Liabilities	19,192	12,862	
Net Deferred Tax Asset Before Valuation Allowance	56,960	72,956	
Valuation allowance:			
Beginning Balance	(17,171	) (13,859	)
Decrease/(Increase) During the Year	(397	) (3,312	)
Ending Balance	(17,568	) (17,171	)
Net Deferred Tax Asset	\$39,392	\$55,785	

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The \$16,393,000 decrease in the Corporation's net deferred tax asset was due to a combination of a decrease in deferred tax assets and an increase in deferred tax liabilities. The largest deferred tax asset decreases were associated with accounting for loans, other than temporary impairment on securities, and other real estate owned in the amounts of \$3,669,000, \$3,261,000 and \$1,988,000, respectively. Partially offsetting these deferred tax asset decreases was the \$2,180,000 net change in the shift of the accounting for pensions and other employee benefits from a deferred tax liability to a deferred tax asset. Finally, the largest deferred tax liability increase of \$7,742,000 resulted from the accounting for unrealized gains on available for sale securities.

The Corporation has recorded a valuation allowance of \$17,568,000 related to deferred state taxes as it does not anticipate having future state taxable income sufficient to fully utilize the deferred state tax asset. This is primarily due to the Corporation's current tax structure as discussed in the "INCOME TAXES" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as item 7 of this Annual Report on Form 10-K.

As of December 31, 2014, the Corporation had approximately \$143,467,000 of state tax loss carryforward available to offset future state taxes. This state loss carryforward has a valuation allowance of approximately \$142,358,000.

The Corporation has approximately \$13,393,000 of additional paid-in capital that is considered restricted resulting from the CFS acquisition. CFS qualified as a bank under provisions of the Internal Revenue Code which permitted it to deduct from taxable income an allowance for bad debts which differed from the provision for losses charged to income. No provision for income taxes had been provided. If in the future this portion of additional paid-in capital is distributed, or the Corporation no longer qualifies as a bank for income tax purposes, income taxes may be imposed at the then applicable tax rates. The unrecorded deferred tax liability at December 31, 2014, would have been approximately \$4,688,000.

NOTE 23

NET INCOME PER SHARE

Basic net income per share is computed by dividing net income by the weighted-average shares outstanding during the reporting period. Diluted net income per share is computed by dividing net income by the combination of all dilutive common share equivalents, comprised of shares issuable under the Corporation's share-based compensation plans, and the weighted-average shares outstanding during the reporting period.

Dilutive common share equivalents include the dilutive effect of in-the-money share-based awards, which are calculated based on the average share price for each period using the treasury stock method. Under the treasury stock method, the exercise price of share-based awards, the amount of compensation expense, if any, for future service that the Corporation has not yet recognized, and the amount of estimated tax benefits that would be recorded in additional paid-in capital when share-based awards are exercised, are assumed to be used to repurchase common stock in the current period.

The following table reconciles basic and diluted net income per share for the years indicated:

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

	2014		2013		2012				
		Weighted-Average Shares		Weighted-Average Shares		Weighted-Average Shares			
Basic net income per share:	\$60,162		\$44,530		\$45,122				
Preferred stock dividends			(2,380 )		(4,539 )				
Net income available to common stockholders	60,162	36,266,356	\$1.66	42,150	29,731,420	\$1.42	40,583	28,632,915	\$1.42
Effect of dilutive stock options and warrants		288,253			276,960			213,769	
Diluted net income per share:									
Net income available to common stockholders	\$60,162	36,554,609	\$1.65	\$42,150	30,008,380	\$1.41	\$40,583	28,846,684	\$1.41

Options to purchase 543,514, 800,674, and 820,706 shares of common stock with weighted average exercise prices of \$20.99, \$21.32, and \$21.58 at December 31, 2014, 2013 and 2012 respectively, were excluded from the computation of diluted net income per share because the options exercise price was greater than the average market price of the common stock.

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## NOTE 24

## QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following table sets forth certain quarterly results for the years ended December 31, 2014 and 2013:

	2014				2013			
	First	Second	Third	Fourth	First	Second	Third	Fourth
Interest income	\$51,009	\$51,527	\$53,290	\$53,053	\$43,738	\$40,653	\$40,736	\$45,707
Interest expense	5,117	5,408	5,424	5,893	4,280	4,003	3,714	4,572
Net interest income	45,892	46,119	47,866	47,160	39,458	36,650	37,022	41,135
Provision for loan losses			1,600	960	2,102	1,997	1,533	1,016
Net interest income after provision for loan losses	45,892	46,119	46,266	46,200	37,356	34,653	35,489	40,119
Non-interest income	15,186	15,933	18,294	16,254	13,877	14,059	11,800	15,073
Non-interest expense	43,089	41,250	42,576	41,677	34,700	33,742	34,219	40,558
Income before income tax expense	17,989	20,802	21,984	20,777	16,533	14,970	13,070	14,634
Income tax expense	4,369	5,642	5,862	5,517	4,668	4,155	2,667	3,187
Net income	13,620	15,160	16,122	15,260	11,865	10,815	10,403	11,447
Preferred stock dividends					(857)	(852)	(430)	(241)
Net income available to common stockholders	\$13,620	\$15,160	\$16,122	\$15,260	\$11,008	\$9,963	\$9,973	\$11,206
Basic EPS	\$0.38	\$0.42	\$0.45	\$0.41	\$0.38	\$0.35	\$0.35	\$0.34
Diluted EPS	\$0.38	\$0.41	\$0.45	\$0.41	\$0.38	\$0.34	\$0.35	\$0.34
Average Shares Outstanding:								
Basic	35,956,436	36,026,763	36,054,867	37,018,014	28,716,987	28,783,407	28,806,809	32,597,145
Diluted	36,260,624	36,294,149	36,328,981	37,323,276	28,971,238	29,023,513	29,081,472	32,912,605

## NOTE 25

## CONDENSED FINANCIAL INFORMATION (parent company only)

Presented below is condensed financial information as to financial position, results of operations, and cash flows of the Corporation.

## Condensed Balance Sheets

	December 31, 2014	December 31, 2013
Assets		

Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Cash	\$36,044	\$13,228
Investment in subsidiaries	820,123	745,818
Goodwill	448	448
Other assets	6,281	8,695
Total assets	\$862,896	\$768,189
Liabilities		
Borrowings	\$126,702	\$126,702
Other liabilities	9,367	6,564
Total liabilities	136,069	133,266
Stockholders' equity	726,827	634,923
Total liabilities and stockholders' equity	\$862,896	\$768,189

Table of Contents

## PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## Condensed Statements of Income and Comprehensive Income

	December 31, 2014	December 31, 2013	December 31, 2012
Income			
Dividends from subsidiaries	\$ 53,231	\$ 63,732	\$ 30,096
Other income	538	45	85
Total income	53,769	63,777	30,181
Expenses			
Interest expense	6,616	3,531	4,655
Salaries and employee benefits	3,128	3,284	3,194
Net occupancy and equipment expenses	442	258	312
Telephone expenses	27	42	30
Postage and courier expenses			1
Other expenses	1,972	2,617	1,502
Total expenses	12,185	9,732	9,694
Income before income tax benefit and equity in undistributed income of subsidiaries	41,584	54,045	20,487
Income tax benefit	3,999	3,153	3,316
Income before equity in undistributed income of subsidiaries	45,583	57,198	23,803
Equity in undistributed (distributions in excess of) income of subsidiaries	14,579	(12,668)	) 21,319
Net income	60,162	44,530	45,122
Preferred stock dividends and discount accretion		(2,380)	) (4,539)
Net income available to common stockholders	\$ 60,162	\$ 42,150	\$ 40,583
Net income	\$ 60,162	\$ 44,530	\$ 45,122
Other comprehensive income (loss)	4,780	(911)	) (1,897)
Comprehensive income	\$ 64,942	\$ 43,619	\$ 43,225

## Condensed Statement of Cash Flows

	Year Ended December 31,		
	2014	2013	2012
Cash Flow From Operating Activities:			
Net income	\$ 60,162	\$ 44,530	\$ 45,122
Adjustments to Reconcile Net Income to Net Cash:			
Share-based compensation	887	778	632
Distributions in excess of (equity in undistributed) income of subsidiaries	(14,579)	) 12,668	(21,319)
Net Change in:			
Other assets	2,425	(1,354)	) 1,902
Other liabilities	1,466	(8,438)	) 1,122
Investment in subsidiaries - operating activities	(4,517)	) 12,991	(1,755)
Net cash provided by operating activities	\$ 45,844	\$ 61,175	\$ 25,704



Edgar Filing: FIRST MERCHANTS CORP - Form 10-K

Cash Flow From Investing Activities:			
Investment in subsidiaries			\$(126 )
Net cash paid in acquisition	\$(12,832 )		
Other		\$240	
Net cash provided (used) in investing activities	\$(12,832 )	\$240	\$(126 )
Cash Flow From Financing Activities:			
Cash dividends	\$(10,694 )	\$(7,992 )	\$(7,442 )
Repayment of borrowings		(55,000 )	(4,124 )
Proceeds from issuance of long-term debt		70,000	
Preferred stock redemption under small business lending fund		(90,783 )	
Stock issued under employee benefit plans	478	479	449
Stock issued under dividend reinvestment and stock purchase plan	523	325	202
Stock options exercised	564	115	78
Stock redeemed	(1,067 )	(491 )	(235 )
Net cash used by financing activities	\$(10,196 )	\$(83,347 )	\$(11,072 )
Net change in cash	22,816	(21,932 )	14,506
Cash, beginning of the year	13,228	35,160	20,654
Cash, end of year	\$36,044	\$13,228	\$35,160

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

NOTE 26

ACCOUNTING MATTERS

FASB Accounting Standards Update No. 2015-01, Income Statement -Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items

The FASB has issued Accounting Standards Update (ASU) No. 2015-01, Income Statement - Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items. The FASB issued this ASU as part of its initiative to reduce complexity in accounting standards.

This ASU eliminates from U.S. GAAP the concept of extraordinary items. Subtopic 225-20, Income Statement - Extraordinary and Unusual Items, required that an entity separately classify, present, and disclose extraordinary events and transactions. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item.

If an event or transaction meets the criteria for extraordinary classification, an entity is required to segregate the extraordinary item from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. The entity also is required to disclose applicable income taxes and either present or disclose earnings-per-share data applicable to the extraordinary item.

The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. A reporting entity may apply the amendments prospectively. A reporting entity also may apply the amendments retrospectively to all prior periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

FASB ASU No. 2014-17 Business Combinations (Topic 805): Pushdown Accounting

The amendments in this Update provide an acquired entity with an option to apply pushdown accounting in its separate financial statements upon occurrence of an event in which an acquirer obtains control of the acquired entity.

An acquired entity may elect the option to apply pushdown accounting in the reporting period in which the change-in-control event occurs. An acquired entity should determine whether to elect to apply pushdown accounting for each individual change-in-control event in which an acquirer obtains control of the acquired entity. If pushdown accounting is not applied in the reporting period in which the change-in-control event occurs, an acquired entity will have the option to elect to apply pushdown accounting in a subsequent reporting period to the acquired entity's most recent change-in-control event. An election to apply pushdown accounting in a reporting period after the reporting period in which the change-in-control event occurred should be considered a change in accounting principle in accordance with Topic 250, Accounting Changes and Error Corrections. If pushdown accounting is applied to an individual change-in-control event, that election is irrevocable.

If an acquired entity elects the option to apply pushdown accounting in its separate financial statements, it should disclose information in the current reporting period that enables users of financial statements to evaluate the effect of pushdown accounting.

The amendments in this Update are effective on November 18, 2014. After the effective date, an acquired entity can make an election to apply the guidance to future change-in-control events or to its most recent change-in-control event. However, if the financial statements for the period in which the most recent change-in-control event occurred already have been issued or made available to be issued, the application of this guidance would be a change in accounting principle. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

FASB ASU 2014-15, Presentation of Financial Statements-Going Concern (Subtopic 204-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern

In August 2014, FASB, issued ASU 2014-15, Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. The update provides U.S. GAAP guidance on management's responsibility in evaluating whether there is substantial doubt about a company's ability to continue as a going concern and about related footnote disclosures. For each reporting period, management will be required to evaluate whether there are conditions or events that raise substantial doubt about a company's ability to continue as a going concern within one year from the date the financial statements are issued. The amendments in this update are effective for annual reporting periods ending after December 15, 2016, and for annual and interim periods thereafter. Early adoption is permitted. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

FASB ASU 2014-14, Receivables-Troubled Debt Restructuring by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure

In August 2014, FASB, issued ASU 2014-14, Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure. The objective of this update is to reduce diversity in practice by addressing the classification of foreclosed mortgage loans that are fully or partially guaranteed under government programs. Currently, some creditors reclassify those loans to real estate as with other foreclosed loans that do not have guarantees; others reclassify the loans to other receivables. The amendments affect creditors that hold government-guaranteed mortgage loans, including those guaranteed by the FHA and the VA. The amendments in this update are effective for annual reporting periods ending after December 15, 2015 and interim periods beginning after December 15, 2015. An entity should adopt the amendments in this update using either a prospective transition method or a modified retrospective transition method. For prospective transition, an entity should apply the amendments in this update to foreclosures that occur after the date of adoption. For the modified retrospective transition, an entity should apply the amendments in the update by means of a cumulative-effect adjustment (through a reclassification to a separate other receivable) as of the beginning of the annual period of adoption. Prior periods should not be adjusted. However, a reporting entity must apply the same method of transition as elected under ASU No. 2014-04. Early adoption, including adoption in an interim period, is permitted if the entity already has adopted update 2014-04. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

FASB ASU 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period

A consensus of the FASB Emerging Issues Task Force. The amendments in this update clarify that entities should treat performance targets that can be met after the requisite service period of a share-based payment award as performance conditions that affect vesting. Therefore, an entity would not record compensation expense (measured as of the grant date without taking into account the effect of the performance target) related to an award for which transfer to the employee is contingent on the entity's satisfaction of a performance target until it becomes probable that the performance target will be met. The ASU does not contain any new disclosure requirements. The ASU is effective for interim and annual reporting periods beginning after December 15, 2015. Early adoption is permitted. In addition, entities will have the option of applying the guidance either prospectively (i.e., only to awards granted or modified on or after the effective date) or retrospectively. Retrospective application would only apply to awards with performance targets outstanding at or after the beginning of the first annual period presented (i.e., the earliest presented comparative period). Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

FASB ASU 2014-11, Transfers and Servicing: Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures

The amendments in this update require entities to account for repurchase-to-maturity transactions as secured borrowings (rather than as sales with forward repurchase agreements), eliminates accounting guidance on linking repurchase financing transactions, and expands disclosure requirements related to certain transfers of financial assets that are accounted for as sales and certain transfers, such as repos, securities lending transactions, and repurchase-to-maturity transactions, accounted for as secured borrowings. The amendments in ASU 2014-11 are effective for annual periods beginning after December 15, 2014. The amendments must present changes in accounting for transactions outstanding on the effective date as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Early application is prohibited. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

FASB ASU 2014-09, Revenue from Contracts with Customers

The amendments in this update supersede virtually all existing GAAP revenue recognition guidance, including most industry-specific revenue recognition guidance. ASU 2014-09 creates a single, principle-based revenue recognition framework and will require entities to apply significantly more judgment and expanded disclosures surrounding revenue recognition. The core principle requires an entity to recognize revenue in a manner that depicts the transfer of goods or services to customers at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 applies to contracts with customers to provide goods and services, with certain exclusions such as lease contracts, financing arrangements, and financial instruments. The amendments in ASU 2014-09 are effective for annual reporting periods beginning after December 15, 2017. Early adoption is permitted for annual reporting periods beginning after December 15, 2016. The Corporation is evaluating the effect of this ASU on its consolidated financial statements.

**Accounting Standards Update (ASU) 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure**

In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure, to reduce diversity by clarifying when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

**ASU 2014-01, Accounting for Investments in Qualified Affordable Housing Projects**

In January 2014, the FASB issued ASU 2014-01, Accounting for Investments in Qualified Affordable Housing Projects, to permit entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. The ASU modifies the conditions that an entity must meet to be eligible to use a method other than the equity or cost methods to account for qualified affordable housing project investments. The ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

Table of Contents

PART II: ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

NOTE 27

GENERAL LITIGATION

The Corporation is subject to claims and lawsuits that arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the consolidated financial position, results of operations and cash flow of the Corporation.

NOTE 28

SUBSEQUENT EVENTS

On January 5, 2015, First Merchants Corporation, an Indiana corporation (“First Merchants”), and C Financial Corporation, an Ohio corporation (“C Financial”), entered into an Agreement and Plan of Reorganization and Merger (the “Merger Agreement”), pursuant to which, C Financial will, subject to the terms and conditions of the Merger Agreement, merge with and into First Merchants (the “Merger,”) whereupon the separate corporate existence of C Financial will cease and First Merchants will survive. Immediately following the Merger, Cooper State Bank, an Ohio state bank and wholly-owned subsidiary of C Financial, will be merged with and into First Merchants Bank, National Association, a national bank and wholly-owned subsidiary of First Merchants, with First Merchants Bank, National Association continuing as the surviving bank. The Merger Agreement has been approved by the Boards of Directors of each of First Merchants and C Financial, but the consummation of the Merger is conditioned upon the approval of the C Financial shareholders and certain regulatory authorities as well as satisfaction of customary closing conditions. The Merger Agreement provides that upon the effective date of the Merger (the “Effective Date”), the shareholders of C Financial shall be entitled to receive an aggregate of \$14,500,000 in cash in exchange for all of the outstanding shares of C Financial common stock, \$1.00 par value. The amount each shareholder will receive will be equal to \$14,500,000 multiplied by a fraction, the numerator of which is the number of shares of C Financial Common Stock held by such shareholder and the denominator of which is the number of shares of C Financial Common Stock outstanding on the Effective Date. Any shareholders who dissent from the Merger in accordance with Ohio Revised Code Sections 1701.84 and 1701.85, as amended, will only receive payment through the dissenters’ rights proceedings. Subject to C Financial common shareholders’ approval of the Merger Agreement, regulatory approvals and other customary closing conditions, the parties anticipate completing the Merger in the second quarter of 2015.

Table of Contents

PART II: ITEM 9., ITEM 9A. AND ITEM 9B.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

In connection with its audits for the two most recent fiscal years ended December 31, 2014, there have been no disagreements with the Corporation's independent registered public accounting firm on any matter of accounting principles or practices, financial statement disclosure or audit scope or procedure, nor have there been any changes in accountants.

ITEM 9A. CONTROLS AND PROCEDURES

At the end of the period covered by this report (the "Evaluation Date"), the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 ("Exchange Act"). Based upon that evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer concluded that, as of the Evaluation Date, the Corporation's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in Corporation reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of First Merchants Corporation (the "Corporation") is responsible for establishing and maintaining effective internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Corporation's internal control over financial reporting is designed to provide reasonable assurance to the Corporation's management and Board of Directors regarding the preparation and fair presentation of published financial statements. As part of its function of assisting the Corporation's Board of Directors in discharging its responsibility of ensuring financial reporting and regulatory risks to the organization are properly being managed, mitigated and monitored by Management, the Audit Committee of the Board of Directors oversees management's internal controls over financial reporting.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Accordingly, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management assessed the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2014. In making this assessment, management used the criteria set forth in "Internal Control - Integrated Framework (1992)" issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. Based on this assessment, management has determined that the Corporation's internal control over financial reporting as of December 31, 2014 is effective based on the specified criteria. As permitted, the Corporation excluded the operations of Community Bancshares, Inc., acquired on November 7, 2014, from the scope of management's report on internal control over financial reporting.

There have been no changes in the Corporation's internal controls over financial reporting identified in connection with the evaluation referenced above that occurred during the Corporation's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

BKD, LLP, the independent registered public accounting firm that audited the financial statements included in Item 8 of this Annual Report on Form 10-K, has issued an attestation report on the Corporation's internal control over financial reporting as of December 31, 2014, which appears as follows.



Table of Contents

PART II: ITEM 9., ITEM 9A. AND ITEM 9B.

Report of Independent Registered Public Accounting Firm

Audit Committee, Board of Directors and Stockholders  
First Merchants Corporation  
Muncie, Indiana

We have audited First Merchants Corporation's (Corporation) internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Corporation's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management's assessment and our audit were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our examination of the Corporation's internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C). A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

As permitted, the Corporation excluded the operations of Community Bancshares, Inc. acquired on November 7, 2014, from the scope of management's report on internal control over financial reporting. As such, this entity has also

been excluded from the scope of our audit of internal control over financial reporting.

In our opinion, First Merchants Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of First Merchants Corporation and our report dated February 27, 2015, expressed an unqualified opinion thereon.

BKD, LLP

Indianapolis, Indiana  
February 27, 2015

ITEM 9B. OTHER INFORMATION

None

103

---

Table of Contents

PART III: ITEM 10., ITEM 11., ITEM 12., ITEM 13. AND ITEM 14.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information in the Corporation's Proxy Statement dated March 25, 2015 furnished to its stockholders in connection with an annual meeting to be held May 4, 2015 (the "2015 Proxy Statement"), under the captions "BOARD OF DIRECTORS"; "CORPORATE GOVERNANCE"; "BOARD COMMITTEES - AUDIT COMMITTEE"; and "SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE", is expressly incorporated herein by reference. The information required under this item relating to executive officers is set forth in Part I, "Supplemental Information - Executive Officers of the Registrant" of this Annual Report on Form 10-K.

The Corporation has adopted a Code of Ethics that applies to its Chief Executive Officer, Chief Financial Officer, Chief Banking Officer, Senior Vice President of Finance, Corporate Controller and Corporate Treasurer. It is part of the Corporation's Code of Business Conduct, which applies to all employees and directors of the Corporation and its affiliates. A copy of the Code of Business Conduct may be obtained, free of charge, by writing to First Merchants Corporation at 200 East Jackson Street, Muncie, IN 47305. In addition, the Code of Ethics is maintained on the Corporation's website, which can be accessed at [www.firstmerchants.com](http://www.firstmerchants.com).

ITEM 11. EXECUTIVE COMPENSATION

The information in the Corporation's 2015 Proxy Statement, under the captions, "BOARD COMMITTEES - COMPENSATION AND HUMAN RESOURCES COMMITTEE - Compensation and Human Resources Committee Interlocks and Insider Participation and Compensation and Human Resources Committee Report"; "BOARD COMMITTEES - RISK AND CREDIT POLICY COMMITTEE"; "COMPENSATION OF EXECUTIVE OFFICERS"; and "COMPENSATION OF DIRECTORS" is expressly incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information in the Corporation's 2015 Proxy Statement, under the captions, "SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT", is expressly incorporated herein by reference. The information required under this item relating to equity compensation plans is set forth in Part II, Item 5 under the table entitled "Equity Compensation Plan Information" on this Annual Report on Form 10-K.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information in the Corporation's 2015 Proxy Statement, under the captions, "CORPORATE GOVERNANCE - BOARD INDEPENDENCE"; and "TRANSACTIONS WITH RELATED PERSONS", is expressly incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information in the Corporation's 2015 Proxy Statement, under the caption "INDEPENDENT AUDITOR", is expressly incorporated herein by reference.



Table of Contents

PART IV: ITEM 15. FINANCIAL STATEMENT SCHEDULES AND EXHIBITS

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

FINANCIAL INFORMATION

(a) 1. The following financial statements are filed as part of this document under Item 8 hereof:

Independent accountants' report

Consolidated balance sheets at December 31, 2014 and 2013

Consolidated statements of income, years ended December 31, 2014, 2013 and 2012

Consolidated statements of comprehensive income, years ended December 31, 2014, 2013 and 2012

Consolidated statements of stockholders' equity, years ended December 31, 2014, 2013 and 2012

Consolidated statements of cash flows, years ended December 31, 2014, 2013 and 2012

Notes to consolidated financial statements

(a) 2. Financial statement schedules:

All schedules are omitted because they are not applicable or not required, or because the required information is included in the consolidated financial statements or related notes.

(a) 3. Exhibits:

Exhibit No: Description of Exhibits:

2.1 Agreement and Plan of Reorganization and Merger between First Merchants Corporation and Community Bancshares, Inc. dated July 21, 2014 (Incorporated by reference to registrant's Form 8-K filed July 22, 2014).

2.2 Agreement and Plan of Reorganization and Merger between First Merchants Corporation and C Financial Corporation dated as of January 5, 2015 (Incorporated by reference to registrant's Form 8-K filed January 6, 2015)

3.1 First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2011)

3.2 Bylaws of First Merchants Corporation dated October 28, 2009 (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2009)

3.3 First Merchants Corporation Articles of Amendment of the Articles of Incorporation for the Series B Preferred Stock (Incorporated by reference to registrant's Form 8-K filed on September 23, 2011)

4.1 First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)

4.2 Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)

4.3 Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)

4.4 Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)

- 4.5 First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Post-Effective Amendment No. 1 to Form S-3 filed on August 21, 2009)
- 4.6 Upon request, the registrant agrees to furnish supplementally to the Commission a copy of the instruments defining the rights of holders of its (a) 5.00% Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million and (b) 6.75% Fixed-to-Floating Rate Subordinated Notes due 2028 in aggregate principal amount of \$65 million. (Incorporated by reference to the registrant's Form 8-K filed on November 4, 2013)
- 10.1 First Merchants Corporation Senior Management Incentive Compensation Program, dated February 26, 2015 (1)
- 10.2 First Merchants Corporation Equity Compensation Plan for Non-Employee Directors, as amended, effective January 1, 2015 (1)
- 10.3 First Merchants Corporation 2009 Long-Term Equity Incentive Plan, as amended, effective January 1, 2015 (1)
- 10.4 Voting Agreement dated July 21, 2014, by and among First Merchants Corporation and certain shareholders of Community Bancshares, Inc. (Incorporated by reference to registrant's Form 8-K filed on July 22, 2014)
- 10.5 First Merchants Corporation Change of Control Agreement, as amended, with Michael C. Rechin dated June 1, 2011 (Incorporated by reference to registrant's Form 10-Q filed on August 9, 2011) (1)
- 10.6 First Merchants Corporation Change of Control Agreement, as amended, with Mark K. Hardwick dated June 1, 2011 (Incorporated by reference to registrant's Form 10-Q filed on August 9, 2011) (1)
- 10.7 First Merchants Corporation Change of Control Agreement, as amended, with Michael J. Stewart dated June 1, 2011 (Incorporated by reference to registrant's Form 10-Q filed on August 9, 2011) (1)
- 10.8 First Merchants Corporation Change of Control Agreement, as amended, with John J. Martin dated June 1, 2011 (Incorporated by reference to registrant's Form 10-Q filed on August 9, 2011) (1)
- 10.9 First Merchants Corporation Change of Control Agreement, as amended, with Kimberly J. Ellington dated June 1, 2011 (Incorporated by reference to registrant's Form 10-Q filed on August 9, 2011) (1)
- 10.10 First Merchants Corporation Change of Control Agreement, as amended, with Jeffery B. Lorentson dated June 1, 2011 (Incorporated by reference to registrant's Form 10-Q filed on August 9, 2011) (1)
- 10.11 First Merchants Corporation Change of Control Agreement, effective February 11, 2014, with Stephan H. Fluhler (Incorporated by reference to registrant's Form 8-K filed on May 12, 2014) (1)

105

---

Table of Contents

PART IV: ITEM 15. FINANCIAL STATEMENT SCHEDULES AND EXHIBITS

10.12	Resolution of the Board of Directors of First Merchants Corporation on director compensation dated December 4, 2007 (Incorporated by reference to the registrant's Form 10-K for year ended December 31, 2007) (1)
10.13	First Merchants Corporation Supplemental Executive Retirement Plan and amendments thereto (Incorporated by reference to registrant's Form 10-K for year ended December 31, 1997) (1)
10.14	First Merchants Corporation Defined Contribution Supplemental Retirement Plan dated January 1, 2006 (Incorporated by reference to registrant's Form 8-K filed on February 6, 2007) (1)
10.15	First Merchants Corporation Participation Agreement of Michael C. Rechin dated January 26, 2007 (Incorporated by reference to registrant's Form 8-K filed on February 6, 2007) (1)
10.16	First Merchants Corporation 2009 Employee Stock Purchase Plan effective July 1, 2009 (Incorporated by reference to registrant's Form 8-K filed on May 11, 2009) (1)
10.17	2011 Executive Deferred Compensation Plan, effective January 1, 2011 (Incorporated by reference to registrant's Form 8-K filed on November 3, 2011) (1)
10.18	Voting Agreement dated January 5, 2015, by and among First Merchants Corporation and certain shareholders of C Financial Corporation (Incorporated by reference to registrant's Form 8-K filed January 6, 2015)
21	Subsidiaries of registrant (2)
23	Consent of Independent Registered Public Accounting Firm (2)
24	Limited Power of Attorney (2)
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (2)
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (2)
32	Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (2)
99.1	Financial statements and independent registered public accounting firm's report for First Merchants Corporation 2009 Employee Stock Purchase Plan (2004) (2)
101.INS	XBRL Instance Document (3)
101.SCH	XBRL Taxonomy Extension Schema Document (3)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (3)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (3)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (3)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (3)

- (1) Management contract or compensatory plan
- (2) Filed herewith.
- (3) Furnished herewith.

Table of Contents

PART IV: ITEM 15. FINANCIAL STATEMENT SCHEDULES AND EXHIBITS

PART IV: ITEM 15. FINANCIAL STATEMENT SCHEDULES AND EXHIBITS

SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on this 27th day of February, 2015.

FIRST MERCHANTS CORPORATION

By: /s/ Michael C. Rechin  
Michael C. Rechin,  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report on Form 10-K has been signed by the following persons on behalf of the registrant and in the capacities indicated, on this 27th day of February, 2015.

/s/ Michael C. Rechin  
Michael C. Rechin, President and  
Chief Executive Officer  
(Principal Executive Officer)

/s/ Mark K. Hardwick  
Mark K. Hardwick, Executive Vice  
President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

/s/ Michael R. Becher\*  
Michael R. Becher, Director

/s/ Michael C. Rechin  
Michael C. Rechin, Director

/s/ Roderick English\*  
Roderick English, Director

/s/ Charles E. Schalliol\*  
Charles E. Schalliol, Director

/s/ F. Howard Halderman\*  
F. Howard Halderman, Director

/s/ Patrick A. Sherman\*  
Patrick A. Sherman, Director

/s/ William L. Hoy\*  
William L. Hoy, Director

/s/ Terry L. Walker\*  
Terry L. Walker, Director

/s/ Gary J. Lehman\*  
Gary J. Lehman, Director

/s/ Jean L. Wojtowicz\*  
Jean L. Wojtowicz, Director

\* By Mark K. Hardwick as Attorney-in Fact pursuant to a Limited Power of Attorney executed by the directors listed above, which Power of Attorney is being filed with the Securities and Exchange Commission as an exhibit hereto.

By: /s/ Mark K. Hardwick



Mark K. Hardwick  
As Attorney-in-Fact  
February 27, 2015